

**COMMISSIONERS**  
MARC SPITZER - Chairman  
JIM IRVIN  
WILLIAM A. MUNDELL  
JEFF HATCH-MILLER  
MIKE GLEASON



ORIGINAL

BRIAN C. MCNEIL  
Executive Secretary

30T

**ARIZONA CORPORATION COMMISSION**

March 28, 2003

Jane Rodda  
Administrative Law Judge  
Hearing Division  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, AZ 85007

Re: Qwest Dex  
Docket No: T-01051B-02-0666

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Dear Judge Rodda:

Staff hereby provides notice to you and the parties that as of today, it has reached a settlement in principal with Qwest in this case. Once the details of the settlement are memorialized, Staff will publish the agreement to other parties, for their review and possible inclusion in the settlement. At that time, Staff will also request a procedural schedule for the filing of testimony by Qwest and Staff in support of the settlement and for the filing of responsive testimony by other parties.

Sincerely,

Christopher C. Kempley  
Chief Counsel  
Legal Division

CCK:daa  
cc: Docket Control  
All Parties of Record

Arizona Corporation Commission

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**MAR 28 2003**

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BEFORE THE ARIZONA CORPORATION COMMISSION

MARC SPITZER  
Chairman  
JIM IRVIN  
Commissioner  
WILLIAM A. MUNDELL  
Commissioner  
JEFF HATCH-MILLER  
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MIKE GLEASON  
Commissioner

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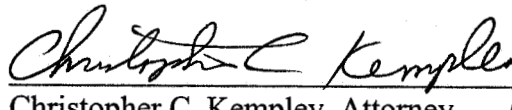
IN THE MATTER OF QWEST  
COMMUNICATIONS INTERNATIONAL )  
INC.'S, QWEST SERVICES )  
CORPORATION'S, AND QWEST )  
CORPORATION'S NOTICE OF SALE, )  
REQUEST FOR WAIVER, OR )  
APPLICATION FOR APPROVAL OF )  
THE SALE OF THE ARIZONA )  
OPERATIONS OF DEX, INC. )

DOCKET NO. T-01051B-02-0666

NOTICE OF FILING  
DIRECT TESTIMONY

Staff hereby provides Notice of Filing its Direct Testimony in this Docket. An Original and fifteen copies of the redacted Direct Testimony of Michael L. Brosch are submitted. Copies of the unredacted version of Mr. Brosch's Testimony are being provided to parties who have executed an appropriate Protective Agreement.

RESPECTFULLY SUBMITTED this 28 day of March, 2003.



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Arizona Corporation Commission  
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ORIGINAL and Fifteen (15) copies  
of the foregoing hand-delivered  
this 28 day of March, 2003, to:

1 Arizona Corporation Commission  
2 Docket Control  
3 1200 West Washington Street  
4 Phoenix, Arizona 85007

5  
6 COPY of the Foregoing hand-delivered  
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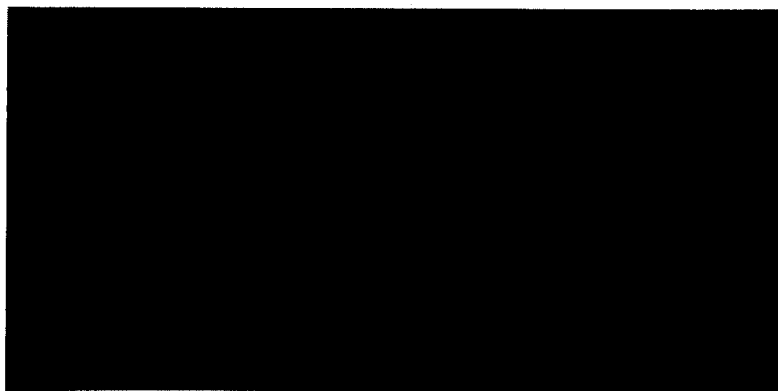
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Deborah A. Amaral  
Assistant to Maureen A. Scott



**ARIZONA CORPORATION COMMISSION  
UTILITIES DIVISION**

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AZ CORP COMMISSION  
CASEMENT CONTROL

**NON-CONFIDENTIAL**

**DIRECT**

**TESTIMONY**

**OF**

**MICHAEL BROSCH**

**IN THE MATTER OF QWEST COMMUNICATIONS, INTERNATIONAL, INC.'S,  
QWEST SERVICES CORPORATION'S, AND QWEST CORPORATION'S NOTICE OF  
SALE, REQUEST FOR WAIVER, OR APPLICATION FOR APPROVAL OF THE SALE  
OF THE ARIZONA OPERATIONS OF QWEST DEX, INC.**

**DOCKET NO. T-01051B-02-0666**

**MARCH 28, 2003**

**BEFORE THE ARIZONA CORPORATION COMMISSION**

In the Matter of Qwest Communications,  
International, Inc.'s, Qwest Services  
Corporation's, and Qwest Corporation's  
Notice of Sale, Request For Waiver, or  
Application for Approval of the Sale of  
the Arizona Operations of Qwest Dex,  
Inc.

Docket No. T-01051B-02-0666

**DIRECT TESTIMONY**

**OF**

**MICHAEL BROSCH**

**ON BEHALF OF THE UTILITIES DIVISION STAFF**

**MARCH 28, 2003**

**Non-Confidential Version**

## Executive Summary of Testimony

Utilitech was retained by the ACC Utilities Division Staff to review and analyze the Application of Qwest in this matter regarding the proposed sale of the Dex directory publishing business. I am a principal of Utilitech and have previously represented the Staff in rate cases and other proceedings involving Qwest and its predecessors over the past 15 years, including analysis of directory publishing issues and the calculation of imputation adjustments associated with directory publishing. I have also testified regarding the sale of Dex transaction in pending proceedings in Utah and Washington.

The sale of Dex represents an extraordinary transaction intended to monetize and liquidate a major segment of Qwest's business, the directory publishing business that has historically been recognized above the line in establishing telephone service rates. The sale of the Dex income stream creates a substantial risk that the large gain on sale and cash proceeds from the transaction will be used to satisfy immediate creditor demands arising primarily from the non-regulated portions of Qwest's business, while the loss of the future income stream produced by directory publishing leaves the overall and regulated business financially weakened. Notably, the Dex sale eliminates an affiliate relationship that has been challenging to regulators for many years, substituting new long-term agreements with the Buyer of Dex that convey valuable assets of the telephone company on a long term basis, even though the QCI parent entity receives all of the proceeds from the sale of Dex.

The sale of Dex terminates the 1988 Settlement Agreement that has provided for directory imputation in Arizona in the past, based upon the fees and value of services received under affiliate publishing agreements. The sale of Dex

1 will eliminate the affiliate publishing arrangement with USWD (now Dex) that was  
2 the basis of the 1988 Settlement Agreement. The Dex sale will also frustrate any  
3 future ability of the Arizona Corporation Commission to consider directory publishing  
4 financial results in evaluating the value of fees and services. While the 1988  
5 Settlement Agreement pertained to and resolved a disputed specific transfer of  
6 certain assets among corporate affiliates that occurred in 1984, the Settlement  
7 Agreement did not contemplate the true sale of the publishing business enterprise  
8 to a non-affiliate at market value. It therefore is now necessary to provide for  
9 adjusted Arizona revenue credits from the sale proceeds to replace the inadequate  
10 levels of compensation provided for in the 1988 Settlement Agreement.

11 In addition, it must be recognized that the sale of Dex yields a very large gain  
12 that represents the full value of the business enterprise being transferred, including  
13 the fees and services being transferred by Qwest Corporation under new Publishing  
14 and Noncompetition Agreements. This gain should not be attributed only to  
15 shareholders, as suggested in the Company's prefiled testimony. Instead, the  
16 intrastate Arizona portion of the realized gain on sale of Dex should be accounted  
17 for as fees and value of services under the principles of the expiring Settlement, and  
18 used to increase the imputation amount embedded within customers' rates. This  
19 prospective adjustment will cause future QC revenue requirements to reflect an  
20 accurate accounting for the Arizona portion of the gain. If traditional regulation is  
21 employed upon expiration of the Arizona Price Cap Plan, I recommend a fixed  
22 annual revenue credit of \$121.3 million per year for each of the next 20 years, in  
23 place of the \$43 million value under the prior agreement. On the other hand, if price  
24 cap regulation is continued after the initial term of the Arizona Price Cap Plan, a  
25 perpetual annual revenue credit of \$100 million per year should be ordered.  
26 Alternatively, if the Commission disagrees with Staff about the termination of the

1 1988 Settlement Agreement and decides to not increase annual revenue credits in  
2 lieu of imputation above the \$43 million annual amount, a large one-time customer  
3 bill credit of no less than \$593 million should be employed to immediately return the  
4 full value of fees and services to customers.

5 These credits and long-term benefits to customers will recognize that  
6 historically Dex has been treated as a source of revenue credits in Arizona and that  
7 ratepayers have a vested interest in the fees and value associated with the directory  
8 business. The calculations supporting these recommendations are set forth in  
9 Confidential Exhibit MLB-1 and are explained in the "Gain on Sale Allocation to  
10 Arizona" section of my testimony.

11 My testimony also rebuts certain assertions by Company witnesses Arnold  
12 and Burnett regarding the impact of the Dex sale upon Qwest Corporation risks and  
13 costs and the sources of value that are being sold with the Dex business. In  
14 particular, I explain why the 1988 Settlement Agreement is not applicable upon sale  
15 of Dex.  
16

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**MICHAEL L. BROSCHE**

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**1 Introduction and Qualifications**

2 Q. Please state your name and business address.

3 A. My name is Michael L. Brosch. My business address is 740 Northwest Blue  
4 Parkway, Suite 204, Lee's Summit, Missouri 64086.

5  
6 Q. By whom are you employed?

7 A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility  
8 rate and regulation work. The firm's business and my responsibilities are related to  
9 special services work for utility regulatory clients. These services include rate case  
10 reviews, cost of service analyses, jurisdictional and class cost allocations, financial  
11 studies, rate design analyses and focused investigations related to utility operations  
12 and ratemaking issues.

13  
14 Q. On whose behalf are you appearing in this proceeding?

15 A. I am appearing on behalf of the Arizona Corporation Commission Utilities Division  
16 Staff ("Staff"). Utilitech entered into a contract with the State of Arizona to review  
17 and respond to the Notice and Application of Qwest Corporation ("Qwest or QC") for  
18 Waiver or Approval of the Sale of the Arizona Operations of Qwest Dex, Inc.  
19 ("Dex").

20  
21 Q. Will you summarize your educational background and professional experience in  
22 the field of utility regulation?

23 A. I graduated from the University of Missouri, Kansas City, in 1978 with a Bachelor of  
24 Business Administration Degree, majoring in accounting. I hold a CPA Certificate in  
25 the State of Missouri and in the State of Kansas. I am a member of the American  
26 Institute of Certified Public Accountants, the Missouri Society of Certified Public

1 Accountants, and the Kansas Society of Certified Public Accountants. Since  
2 completion of formal education, my entire professional career has been dedicated to  
3 utility operations and regulation consulting.  
4

5 From 1978 to 1981, I served as a public utility accountant with the Staff of the  
6 Missouri Public Service Commission. While employed by the Missouri Commission,  
7 I participated in rate case examinations involving electric, gas, water, steam, transit,  
8 and telephone utilities operating in Missouri. In December 1981, I accepted  
9 employment with Troupe Kehoe Whiteaker & Kent, a Kansas City CPA firm, in its  
10 public utility department. While with Troupe Kehoe Whiteaker & Kent, I was  
11 involved in the review, analysis, and presentation of a wide range of utility rate case  
12 issues and various other utility management advisory functions for both utility  
13 company and regulatory agency clients. In May 1983, I commenced employment  
14 with Lubow, McKay, Stevens and Lewis, an accounting and public utility consulting  
15 firm. While employed by that firm, I was involved in numerous regulatory  
16 proceedings and directed work related to various special projects.  
17

18 In June 1985, Dittmer, Brosch and Associates, Inc. (now Utilitech, Inc.) was  
19 organized. The firm specializes in public utility regulatory and management  
20 consulting in the electric, gas, telecommunications, water, and waste water  
21 industries. As a principal of the firm, I am responsible for the supervision and  
22 conduct of the firm's various regulatory projects. A majority of the firm's business  
23 involves representation of utility commission staff and consumer advocate  
24 interveners in utility rate proceedings and special or focused investigations. In  
25 1992, the firm was renamed Utilitech, Inc.  
26

1 I have testified before utility regulatory agencies in Arizona, Arkansas, California,  
2 Florida, Hawaii, Illinois, Indiana, Iowa, Kansas, Michigan, Missouri, New Mexico,  
3 Ohio, Oklahoma, Utah, Washington and Wisconsin in regulatory proceedings  
4 involving electric, gas, telephone, water, sewer, transit, and steam utilities.  
5

6 Q. Have you previously participated in Qwest or U S West Communications ("USWC")  
7 regulatory proceedings?

8 A. Yes. My firm has represented various clients in prior Qwest/USWC proceedings in  
9 several states. In Arizona, I participated in the last four Arizona general rate cases  
10 involving Qwest/USWC on behalf of the Arizona Corporation Commission ("ACC")  
11 Staff and supported the Staff in negotiating a Price Cap Plan in settlement of the  
12 most recent rate case.<sup>1</sup> In Washington, I assisted the Attorney General's Office,  
13 Public Counsel Section, in negotiation and subsequent review of that State's  
14 Alternative Form of Regulation (AFOR) plan.<sup>2</sup> I was also a witness in the two  
15 subsequent Washington general rate cases involving USWC and in a 1998  
16 proceeding dealing exclusively with directory imputation issues.<sup>3</sup> In New Mexico, I  
17 served as a witness for the Commission Staff in the most recent USWC rate case.<sup>4</sup>  
18 In Utah, I served as witness for the Committee of Consumer Services in USWC's  
19 last general rate case and sponsored the directory imputation amount approved by  
20 the Commission in that Docket.<sup>5</sup> I also represented consumer advocate clients in  
21 Utah, Iowa and Washington in regulatory proceedings associated with the

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1 ACC Docket Nos. E-1051-88-146, E-1051-91-004, E-1051-93-183, and E-1051B-99-105  
2 WUTC Docket Nos. U-89-2698-F and U-89-3245-P  
3 WUTC Docket Nos. UT-950200, UT-970766 and UT-980948.  
4 PRC Case No. 3008.  
5 Utah Docket No. 97-049-08

1 acquisition of USWC by Qwest.<sup>6</sup> I am also presently involved in the Dex Sale  
2 Dockets pending in Utah and in Washington.

3  
4 Q. What is the purpose of your testimony in this Docket?

5 A. My testimony is intended to describe and sponsor, on behalf of the Staff, an  
6 explanation of how the sale of Dex will impact QC and recommendations regarding  
7 certain conditions and ratemaking treatment that should be imposed if the sale of  
8 Dex is approved by the Commission. Without such conditions and the proposed  
9 ratemaking treatment, the proposed sale of Dex is not in the public interest and  
10 should not be approved.

11  
12 Q. How is the balance of your testimony organized?

13 A. My testimony is arranged by major topical area. A Table of Contents appearing at  
14 the beginning of the testimony sets forth this organization.

15 **The Dex Sale Transaction**

16 Q. Please describe the pending transaction to sell Qwest Dex.

17 A. Qwest Communications International, Inc. ("QCI"), the ultimate parent company  
18 owning Qwest Corporation, Qwest Dex and numerous other subsidiaries<sup>7</sup>, has  
19 contracted to sell its entire interest in Qwest Dex, Inc. to a consortium of buyers  
20 including the Carlyle Partners III, CP III Coinvestment, L.P., and Welsh Carson,  
21 Anderson & Stowe IX, L.P. (hereinafter, "Buyer"). The sale of Dex is to occur in two  
22 stages, generally including the eastern portion of Qwest's local service territory in a  
23 "Dexter" transaction that has already closed, with a second stage "Rodney"

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6 Utah Docket No. 99-049-41, Iowa Case No. SPU-99-27, Washington Docket No. UT-991358.

7 A Qwest Corporate Structure chart appears as Appendix A, attached to the Company's Notice of Sale, Request for Waiver or Application for Approval in this Docket.

1 transaction scheduled to close later in 2003. Consideration to be received by QCI is  
2 total cash of up to \$7.05 billion, unless the Buyer requests QCI to retain an equity  
3 position of up to \$217 million and/or provide debt financing to the Buyer to not  
4 exceed \$300 million.

5 To transfer the value of the Dex business as a going concern, numerous  
6 commercial agreements are incorporated into the Dexter and Rodney Purchase  
7 Agreements. These include a Publishing Agreement, a Directory List License  
8 Agreement, a Billing & Collection Agreement, a Noncompetition Agreement, a  
9 Trademark License Agreement and several other conveyance and service  
10 arrangement contracts. Collectively, these documents are intended to convey the  
11 entire Dex business to the Buyer in a manner that transfers the personnel,  
12 management, physical assets and automated systems, as well as rights to use  
13 significant intangible assets of Qwest without disruption of the business or dilution of  
14 the considerable going concern value of Dex.

15  
16 Q. Why is it appropriate to characterize the sale of Dex as an extraordinary event?

17 A. The proposed sale represents the liquidation of a major segment of the  
18 consolidated Qwest business, the directory publishing segment that has historically  
19 been treated as a regulatory asset.<sup>8</sup> A portion of the operating revenues, expenses  
20 and resulting income of this business segment have consistently been recognized  
21 within jurisdictional income for ratemaking purposes in Arizona and other states. In  
22 this sense, QC customers have a continuing claim upon the value of the directory

---

8 Prior to 1984, directory publishing was performed within Mountain Bell, with the publishing revenues and expenses recorded in above-the-line accounts. Starting in 1984, directory publishing was performed by a corporate affiliate pursuant to a Publishing Agreement and other affiliate contracts. In Arizona, litigation surrounding the transfer of assets and the affiliate Publishing Agreement was resolved in the 1988 Settlement Agreement that preserved above the line recognition of directory publishing income, subject to a showing of the value of fees and services to deviate from a \$43 million imputation value.

1 publishing operation, even though a formal accounting for this claim has not been  
2 required.<sup>9</sup> Never before has the directory publishing business of the incumbent local  
3 exchange carrier ("ILEC") in the Arizona Qwest territory not been under common  
4 ownership and control with the ILEC.  
5

6 Q. Isn't it true that the directory publishing business owned by Qwest and its  
7 predecessors has been transferred among affiliated entities in prior years?

8 A. Several internal reorganizations of the Qwest directory business have occurred in  
9 the past. These include the transfer of cash and certain directory assets into the  
10 new publishing affiliate in late 1983, the formation of U S West Communications and  
11 Media Group tracking stocks in 1995, with Dex being included as part of the Media  
12 Group, the 1998 spinoff of Media Group with Dex being purchased back by New U  
13 S West and then the merger with Qwest in July 2000.<sup>10</sup> However, there has never  
14 before been a true sale of Dex at market value to a non-affiliated entity reflecting an  
15 arm's-length transaction and objective valuation of the directory publishing business  
16 enterprise. The sale of Dex therefore represents the extraordinary liquidation of a  
17 part of Qwest's Arizona jurisdictional income stream that will no longer be available  
18 to support the Company's financial health or to contribute to its jurisdictional income  
19 for regulatory purposes.  
20

21 Q. How was the Dex purchase price of \$7.05 billion determined?

22 A. The purchase price was the result of negotiations between Qwest and the Buyers  
23 and appears to be reflective of the financial distress being experienced by Qwest as

---

9 This customer claim upon the value associated with directory publishing was not required to be recorded as either a regulatory asset or regulatory liability pursuant to Statement of Financial Accounting Standard No. 71.

10 Qwest response to Data Request STF 1-02.

1 a result of its debt burden and lack of liquidity to service its debts.<sup>11</sup> The negotiated  
2 \$7.05 billion purchase price is (START CONFIDENTIAL) [REDACTED]  
3 [REDACTED]. (END  
4 CONFIDENTIAL) I will explain the concerns with the purchase price later in the  
5 "Gain on Sale Allocation to Arizona" section of my testimony.

6  
7 Q. Even at the \$7.05 billion price that you characterize as reflective of Qwest's financial  
8 distress, will the Company realize a large gain on sale that should be addressed by  
9 the Commission in this proceeding?

10 A. Yes. According to estimates prepared in the confidential response to Staff Data  
11 Request 2-68, the pretax gain on sale expected to result from the Dex sale is  
12 approximately (START CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL) billion. After  
13 consideration of income taxes and the various allocations required to determine an  
14 Arizona share of this gain, I believe that Arizona customers are entitled to a present  
15 value net benefit of no less than (START CONFIDENTIAL) [REDACTED] (END  
16 CONFIDENTIAL) million in after-tax dollars, which is equivalent to (START  
17 CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL) in revenue requirements.  
18 The detailed calculation of this gain allocation is set forth in Confidential Exhibit  
19 MLB-1 attached to this testimony and is described in the "Gain on Sale Allocation to  
20 Arizona" section of my testimony. The form in which Arizona's share of this gain  
21 should be attributed to customers is discussed in the "Recommended Conditions  
22 Upon Approval" section of this testimony.

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11 On December 23, Qwest announced a successful private debt exchange that will reduce total outstanding debt from approximately \$24.5 billion to \$22.6 billion and will extend some near-term maturities. In the Qwest Press Release announcing the debt exchange, the Company stated, "Over the past six months, Qwest's new leadership team has accomplished a number of steps to reduce debt and improve liquidity, including closing the sale of the first phase of its directory publishing business, QwestDex; amending the company's credit facility; and completing a new term loan."

1  
2 Q. How does Qwest plan to utilize the cash proceeds from the sale of Dex?

3 A. The net cash realized from the Dex sale, to the extent not mandated for attribution  
4 to Qwest Corporation customers by order of regulators, is intended to be directed  
5 toward the repayment of debt. The Company restructured its debt around an  
6 amended credit facility and term loan associated with the Dex sale transactions.  
7 Sections III and IV of Mr. Johnson's testimony and Section IV of Mr. Cummings'  
8 testimony describe the financial circumstances of the Company and the importance  
9 of the Dex sale in improving corporate liquidity. The recommendations contained  
10 herein give careful consideration to the Company's planned repayment of debt as  
11 well as customers' entitlement to participation in the realized gain associated with  
12 the sale of Dex.

13  
14 Q. Will Qwest be required to pay income taxes on the gain it realizes from the sale of  
15 Dex?

16 A. Certain of the financial analyses prepared by Qwest's financial advisors in the  
17 transaction suggest that the (START CONFIDENTIAL) [REDACTED]  
18 [REDACTED]  
19 [REDACTED]  
20 [REDACTED] (END CONFIDENTIAL), will offset the income tax liability  
21 otherwise payable on the Dex sale gain.<sup>12</sup> In response to Data Request STF 2-118,  
22 the Company estimated its consolidated NOL carryforward position to be  
23 approximately \$5.82 billion as of December 31, 2001. However, since Qwest  
24 Corporation's regulated ILEC business and the directory publishing business have

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12 STF 2-57, Attachment B, Merrill, Lynch Transaction Overview at page 2, (START CONFIDENTIAL) [REDACTED]  
[REDACTED]

1       been consistently profitable, such NOL income tax benefits arise from non-regulated  
2       business segments and should not be attributed to any gain considered for crediting  
3       to telephone customers.  
4

5       Regarding income tax liability, the key point is that the sale of Dex creates an  
6       opportunity for QCI to realize a cash benefit for its NOL carryforward position that is  
7       being retained for its shareholders because my recommendations provide for  
8       income taxes at statutory tax rates as if the entire gain on sale is taxable. Stated  
9       differently, the calculated income tax expenses allowed in Confidential Exhibit MLB-  
10      1 on the Dex sale gain will not be immediately paid to the government, but will  
11      instead allow the parent company, Qwest Communications International, Inc.  
12      ("QCI"), to convert its NOL position into additional cash for use in repayment of debt.  
13

14    Q.    Would the Company be selling the Dex business if not for the poor financial  
15           performance of its non-regulated businesses?

16    A.    No. As explained in the testimony of Qwest witness Mr. Cummings, "The sale of  
17           Dex (both phases) remains critical to Qwest's ability to avoid bankruptcy in the short  
18           and intermediate term."<sup>13</sup> Notably, the financial difficulties and liquidity concerns  
19           explained by Mr. Cummings and Mr. Johnson came in with the Qwest acquisition  
20           and have not been shown to be related to the financial performance of the  
21           traditional "U S West" ILEC business.  
22  
23  
24

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(END CONFIDENTIAL).

13       Direct testimony of Peter Cummings, page 10.

1 Q. What characteristics of the Dex business make it so valuable to the Buyer?

2 A. Dex is a unique business enterprise encompassing the incumbent directory  
3 publishing position in the 14 states served by Qwest Corporation. Because of its  
4 position, Dex produces a consistently strong and growing stream of income and  
5 cash flow while requiring minimal capital expenditures. These characteristics are of  
6 sufficient value to yield over \$7 billion in a distress sale of the business because the  
7 Buyers will enjoy this income stream upon sale of Dex. Unfortunately, QCI will  
8 sorely miss the income and cash flow produced by Dex after the sale, but the  
9 Company had little choice but to monetize this asset to meet the demands of its  
10 creditors.

11  
12 Q. How do the commercial agreements that are incorporated into the Dex Purchase  
13 Agreement influence the value of the business?

14 A. The commercial agreements are essential to convey the full value of the business to  
15 the Buyers because, without such agreements, Dex cannot function as a going  
16 concern in its present form. The new Publishing Agreement designates the Buyer  
17 as the "exclusive official publisher of all Directory Products" in the regions served by  
18 Qwest Corporation for the next 50 years, as well as a limited grant of "branding  
19 rights" to use the Dex names and marks and designation of the Buyer to receive all  
20 business referrals for directory advertising from within the Qwest Corporation  
21 region.<sup>14</sup> To preserve the public identity of the transferred business, a Trademark  
22 License Agreement grants the Buyer the right to use the "Qwest Dex" name in the  
23 conduct of the business.<sup>15</sup> Access to listings data, expanded use of listings,  
24 payphone placement rights, certain transition services and billing and collection

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14 Exhibit D, Publishing Agreement, at paragraph 4.2.

15 Exhibit J, Trademark License Agreement, paragraph 2.1 and Appendix A.

1 services are provided for in other commercial agreements, which preserve the  
2 existing interfaces between Dex and the telephone company.<sup>16</sup> Without these  
3 agreements, the value of the Dex business enterprise would be substantially  
4 diminished.

5  
6 Q. Is there a completely new agreement associated with the Dex sale that did not exist  
7 previously, when Dex was a wholly-owned affiliate of the telephone company?

8 A. Yes. A new Noncompetition Agreement appears as Exhibit M to the Dex Purchase  
9 Agreements. The Noncompetition Agreement obligates Qwest and its subsidiaries  
10 to not "publish, market, sell or distribute any Directory Products" in competition with  
11 the Buyers interests for a period of forty years, as long as the Buyer performs in  
12 accordance with the terms of the Publishing Agreement.<sup>17</sup> This new Agreement has  
13 the effect of precluding Qwest or its telephone operating subsidiary from re-entering  
14 the directory publishing business to attempt a take back of the directory advertising  
15 profits typically earned by the incumbent telephone holding company. Notably,  
16 there was no need for a Noncompetition Agreement between Dex and its telephone  
17 operating affiliate prior to the transaction because the common parent entity was  
18 able to direct the telephone company to not compete with Dex.

19  
20 Q. How is the current proposed sale of Dex different from the 1984 transaction that  
21 created Dex's predecessor as a separate corporate entity?

22 A. The creation of U S West Direct in 1984 involved a non-arm's length transfer  
23 between corporate affiliates of employees, working capital and limited physical  
24 assets at book value, so as to move the directory publishing business outside of the

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16 See Exhibits E, F, I, K and G respectively.

17 Exhibit M, Noncompetition Agreement, paragraphs 2.1 and 6.3. This Agreement also provides for non-

1 telephone company (at that time Mountain Bell). There was no consideration given  
2 for the fair market value of the directory publishing business enterprise in 1984 and  
3 there was no payment made to the telephone company for the fair value of the  
4 business at that time. The considerable intangible assets associated with the  
5 directory business that were to be used by U S West Direct in the conduct of the  
6 business were not permanently transferred to the publishing affiliate in 1984.  
7 Instead, for a limited period of time, a publishing fee was paid by U S West Direct to  
8 Mountain Bell to partially compensate for the valuable official publishing rights, trade  
9 names and marks, incumbent publisher position and other benefits associated with  
10 affiliation with Mountain Bell. Later, these publishing fees were ceased by  
11 agreement to amend the publishing agreement between the telephone and  
12 publishing affiliates, to the extreme detriment of the telephone company, forcing  
13 regulators in Arizona and other states to impute directory profits into the telephone  
14 company income statement to correct for inappropriate compensation from the  
15 directory publishing affiliate.

16 In contrast to the contrived affiliate transactions of prior years, the pending  
17 Dex sale is a true sale of the directory business for a negotiated cash price  
18 determined through interaction of informed parties in possession of relevant  
19 valuation information. The \$7.05 billion sale price is at the low end of the market  
20 value of the Dex income stream<sup>18</sup> and is based in large part upon the continued use  
21 of the official directory status of Qwest's directories in the new Publishing  
22 Agreement, as well as Noncompetition Agreement and the use of other Qwest  
23 intangible assets granted to the Buyer in the various commercial agreements. For

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solicitation of employees and Dex senior management for a period of two years at Article 4.

18 See valuation summary pages from the confidential response to Data Request STF 2-58, Attachments B and C, specifically the Dex valuation summary charts prepared by Merrill Lynch and Lehman Brothers, as presented to the Qwest Board of Directors August 19, 2002.

1 the first time since the directory business was removed from the telephone company  
2 by affiliate transaction in 1983, regulators are now able to review a market valuation  
3 of the directory publishing rights associated with the incumbent local exchange  
4 telephone business and determine an appropriate regulatory treatment for the Dex  
5 transaction.

6  
7 Q. Are there practical regulatory problems created by the sale of Dex if it is approved  
8 by the Commission?

9 A. Yes. The current liquidity problems faced by QCI are mitigated in the short term by  
10 using the Dex sale cash proceeds to satisfy creditors. However, as noted  
11 elsewhere in my testimony, the substantial annual Dex income and free cash flows  
12 will no longer be available to QCI to meet ongoing capital requirements in the longer  
13 term. The regulated telephone service business is inherently capital intensive, such  
14 that service quality is dependent upon continuing access to capital on reasonable  
15 terms. Absent an improvement in QCI operating and cash flow results beyond  
16 2004, it is conceivable that the Dex sale represents only a temporary solution to  
17 more chronic problems impacting the Company's access to capital on reasonable  
18 terms. Therefore, one problem faced by the Commission is the continued weak and  
19 potentially worsening long-term financial condition of QCI after the Dex income  
20 stream is monetized.<sup>19</sup>

21 Another problem created by the pending Dex sale is the loss of access to  
22 financial data for Dex to aid in evaluating the value of fees and services pursuant to  
23 the Settlement Agreement. In the most recent Arizona rate case, the Company

---

19 In the highly confidential response to Staff Data Request 2-155S1, the Company provided projections of its cash flow and cash balances after meeting debt service and after the sale of Dex and the results indicate (START CONFIDENTIAL)

(END CONFIDENTIAL).

1 sought complete elimination of the \$43 million imputation value by asserting certain  
2 claims regarding the "value of fees and services" provided by Dex and quantified  
3 from Dex financial information. My testimony, in opposition to Qwest's witness,  
4 explained the reasonableness of more than \$43 million in imputation under the  
5 Settlement Agreement, relying upon available Dex financial data. Ultimately, the  
6 negotiated resolution of the rate case left the embedded \$43 million of imputation  
7 unchanged. However, any future rate case reconsideration of "the value of fees  
8 and services" would be frustrated by the absence of any Dex financial data needed  
9 for such analyses. This is why a permanent resolution of imputation issues is  
10 required in connection with any sale of the Dex business enterprise.

11 Finally, the sale of Dex and the large gain on sale to be realized by QCI from  
12 the transaction requires regulatory attention to replace or restate the 1988  
13 Settlement Agreement that is no longer applicable upon sale of Dex. The \$43  
14 million directory imputation value that is embedded within the Arizona revenue  
15 requirement is insufficient to fully recognize the Arizona value of fees and services  
16 being realized in the form of Dex sale gains.

17  
18 **The 1988 Arizona Settlement Agreement**

19 Q. According to the Testimony of Ms. Maureen Arnold, the ACC has already approved  
20 the transfer of the directory business in the 1988 Settlement Agreement and the  
21 Court of Appeals has found the Commission "unequivocally agreed in 1988 to  
22 accept the transfer of directory publication to an unregulated subsidiary." Do you  
23 agree with this characterization?

1 A. No. The 1988 Settlement Agreement was entered into to resolve litigation  
2 surrounding an earlier and quite different transaction between corporate affiliates.<sup>20</sup>  
3 A true and complete sale of the directory publishing business was not contemplated  
4 or addressed by the 1988 Settlement Agreement. In contrast, the pending Dex sale  
5 is a true sale of the business to a non-affiliate for cash consideration at a market  
6 determined price. Before the Dexter/Rodney transactions, a permanent and  
7 complete transfer or sale of the directory publishing business had never occurred.

8 The issues resolved by the 1988 Settlement Agreement were also tied to an  
9 ongoing affiliate business relationship for which specific settlement provisions were  
10 implemented that will no longer apply. The 1988 Settlement Agreement specifically  
11 references the affiliate publishing agreement with USWD and fees payable under  
12 such agreements – but these agreements will no longer exist after Dex is sold.  
13

14 Q. How was the directory asset transfer, that was initially voided in ACC Decision No.  
15 55755 and that is referenced in the 1988 Settlement Agreement, different from the  
16 sale of the directory publishing business that is now pending with the Buyer of Dex?

17 A. Decision No. 55755 voided the inappropriate transfer of certain Yellow Pages  
18 assets from the telephone company to a corporate affiliate. The Commission was  
19 not dealing with a bona-fide sale of the business or with reasonably compensatory  
20 proceeds from such a true sale. Instead, a valuable publishing operation was  
21 illegally transferred to an affiliate for inadequate compensation, causing the  
22 Commission to conclude, "We believe it is in the best interest of the public for

---

20 Paragraph 3 of the Settlement Agreement resolves issues arising from "the transfer of Yellow Pages assets from Mountain Bell to USWD", including the dismissal of Action No. CV 87-33850, the Commission taking "no further action to challenge that transfer, and prescription of imputation methods applicable to "publishing agreements with USWD".

1 Mountain Bell to assume control over its Yellow Pages asset.”<sup>21</sup> As noted by Ms.  
2 Arnold, the Company appealed Decision No. 55755 to the Superior Court and this  
3 appeal was resolved through the 1988 Settlement Agreement. Because there was  
4 no true sale of the directory business in 1984 with reasonable, market-based  
5 compensation to benefit the telephone company and its ratepayers, the 1988  
6 Settlement Agreement required an ongoing compensation payment be imputed in  
7 the annual amount of \$43 million, subject to adjustment for changes in “fees and  
8 value of services”. Recognizing the risk that publishing fees being paid pursuant to  
9 affiliate contracts could be easily modified or reduced, the Settlement Agreement  
10 also required “...more than a showing by Mountain Bell that it negotiated a lesser  
11 amount with USWD” before the \$43 million value could be adjusted downward.  
12

13 Q. You have explained that the 1988 Settlement Agreement pertained to an earlier  
14 affiliate transfer of assets and required \$43 million in annual compensation to the  
15 telephone company, irrespective of negotiated terms within affiliate publishing  
16 agreements. Please summarize the reasons why you believe the 1988 Settlement  
17 Agreement does not apply to the pending Dex sale transaction.

18 A. The reasons why the 1988 Settlement Agreement does not apply to the pending  
19 sale of Dex include the following:

- 20 • The 1988 Settlement Agreement applied to a specific transfer of assets  
21 between corporate affiliates, referred to as “that transfer” at paragraph 3(b).  
22 It did not apply to the complete sale of Dex to a non-affiliate or to long term  
23 assignment of official publisher status with a Noncompetition covenant.
- 24 • The 1988 Settlement Agreement is to be administered by reference to “fees  
25 and the value of services received by Mountain Bell from USWD under

---

21 ACC Decision No. 55755 (10/8/87), page 6.

1 publishing agreements with USWD", but there will no longer be any  
2 publishing agreements "with USWD" or any comparable affiliate.

- 3 • The 1988 Settlement Agreement provides "that Mountain Bell and the  
4 Commission Staff may present evidence in support of or in contradiction to  
5 those fees and the value of those services", but the source of such value  
6 evidence currently resides within Dex and will no longer be available for such  
7 an evidentiary showing after the business is sold to a third party.
- 8 • Paragraph 3(d) of the Settlement Agreement requires that, "the Commission  
9 will be provided with reasonable access to the financial records of USWD for  
10 the purpose of verifying the amount of fees received by Mountain Bell from  
11 USWD under publishing agreements with USWD and the value of services  
12 provided by/to Mountain Bell to/by USWD." After the business is sold, there  
13 will be no "reasonable access" to financial records of USWD or any other  
14 affiliate publisher.
- 15 • The same paragraph 3(d) provides that "if the records of USWD are not  
16 maintained on a basis comparable to that of a regulated utility, Mountain Bell  
17 agrees that the Commission will be provided with any available accounting  
18 records reconciling or relating the fees and the value of services received by  
19 Mountain Bell from USWD under publishing agreements with USWD to the  
20 accrual basis of accounting." It is at least impractical and likely impossible to  
21 maintain sufficient access to the Buyer's accounting records for Qwest, as  
22 successor to Mountain Bell, to comply with this obligation.

23  
24 For these reasons, it is my belief that the 1988 Settlement Agreement is not  
25 applicable to the pending sale of Dex or in rate proceedings after such a sale.  
26

1 Q. Paragraph 3(b) of the 1988 Settlement Agreement states, "For purposes of this  
2 settlement (and not as an admission by Mountain Bell that the Commission has  
3 jurisdiction over the Yellow Pages asset transfer or an admission by the  
4 Commission that it does not have jurisdiction over the Yellow Pages asset transfer)  
5 the parties agree that the transfer of Yellow Pages assets from Mountain Bell to  
6 USWD will be accepted by the parties as valid and the Commission will take no  
7 further action to challenge that transfer." What transaction is being referenced as  
8 "that transfer"?

9 A. Within the Settlement Agreement, preceding paragraphs 1, 2 and 3(a) all clearly  
10 relate to the transfer of assets between affiliates occurring at divestiture, as  
11 addressed in Decision No. 55755 and Action No. CV 87-33850. It is unreasonable  
12 to construe this Decision to anticipate future sale events involving the entire  
13 directory publishing business and all rights to participate in such business to be "that  
14 transfer". The pending sale of Dex is not "that transfer" being referenced within the  
15 1988 Settlement Agreement. What is being sold with Dex at this time is not the  
16 cash and tangible assets that were transferred into the affiliate in late 1983, but  
17 rather the valuable official publishing rights, Noncompetition Agreement and other  
18 intangible assets that represent the going concern value of the business.  
19

20 Q. For what reasons did the Commission reject the initial transfer of assets to USWD?

21 A. ACC Decision No. 55755 concluded that, "Telephone directories, including the  
22 'Yellow Pages' are necessary or useful in the performance of telephone service to  
23 the public" and that "Mountain Bell violated A.R.S. § 40-285 by its disposition of  
24 'Yellow Pages' directory publishing assets without Commission approval."<sup>22</sup>  
25 Decision No. 55755 at page 6 required Mountain Bell to reassume control over

---

22 Id. Conclusions of Law 3 and 5.

1 directory publishing and envisioned an interim period during which a rate case may  
2 occur, with the following instruction for directory imputation in this period:

3 Pending completion of the reassumption of control by Mountain Bell  
4 over the Yellow Pages, we believe it is in the best interests of the  
5 public to impute the amount of net revenues at Mountain Bell's next  
6 rate case based on the following:

7 (1) The entire Arizona related profits of Direct or \$43 million as  
8 adjusted for inflation since the last Test Year, whichever number is  
9 higher, and;

10 (2) The above net revenues will be presumed correct but will be  
11 adjusted if Mountain Bell can convince the Commission otherwise.  
12 Clearly, however, it will take a greater showing by Mountain Bell than  
13 an amount based upon a negotiated agreement with Direct.  
14

15 When the appeal of Decision No. 55755 was resolved in the 1988 Settlement  
16 Agreement, an effort was made to maintain this presumptively correct \$43 million  
17 value subject to a showing in support of any different amount.  
18

19 Q. Paragraph 3[c] of the 1988 Settlement Agreement refers to "fees received from  
20 USWD under publishing agreements with USWD". What were these "fees"?

21 A. The initial affiliate Publishing Agreement between U S West Direct and Mountain  
22 Bell provided for large annual payments to the telephone company of "publishing  
23 fees" to compensate for the valuable right to serve as the official publisher of  
24 directories on behalf of the incumbent Bell telephone company. The payment of  
25 these fees might have pacified regulators that loss of the directory publishing assets  
26 would not harm telephone ratepayers. In fact, the 1988 Settlement Agreement in  
27 Arizona attempted to make permanent a \$43 million minimum receipt of such "fees"  
28 by Mountain Bell through agreement that, "in subsequent rate cases downward  
29 adjustments from the \$43 million in fees received by Mountain Bell from USWD and  
30 included in Mountain Bell's 1984 rate case will require more than a showing by

1 Mountain Bell that it negotiated a lesser amount with USWD". The parties  
2 acknowledged the non-arm's length nature of affiliate publishing agreements and  
3 feared U S West's ability to unilaterally reduce publishing fees to the detriment of  
4 Mountain Bell and its ratepayers.  
5

6 Q. Did U S West unilaterally reduce publishing fees payable to Mountain Bell under  
7 affiliate publishing agreements?

8 A. Yes. The affiliate Publishing Agreement was amended in 1988 to eliminate the  
9 payment of fees. This act was blatantly imprudent on the part of telephone  
10 company management and revealed the transfer of directory assets to be a  
11 regulatory strategy to secure most or all of the directory publishing profits for  
12 shareholders instead of ratepayers. In Arizona, directory imputation levels  
13 remained in dispute in subsequent rate cases in spite of the existence of the 1988  
14 Settlement Agreement.  
15

16 Q. Was the \$43 million imputation value provided for in the 1988 Settlement  
17 Agreement adequate consideration for ratepayers?

18 A. No. The 1988 Settlement Agreement has been a persistently bad deal for  
19 ratepayers. The Settlement Agreement failed to provide for any growth in directory  
20 publishing revenues or profits, effectively leaving all of such growth for the sole  
21 benefit of shareholders. My testimony in the 1993 USWC rate case supported an  
22 increase in imputation from \$43 million to about \$60 million and the Commission's  
23 Decision No. 58927 approved this increased imputation. However, as noted at  
24 page 9 of Ms. Arnold's testimony, USWC successfully appealed the Commission's  
25 Order based upon the 1988 Settlement Agreement requirement that imputation was  
26 limited to "fees and the value of services received by USWC from USWD under

1 publishing agreements with USWD". The Commission was forced to increase rates  
2 to reflect reduced imputation back to the \$43 million level, even though it had found  
3 higher imputation to be more reasonable.  
4

5 Q. After using the 1988 Settlement Agreement to appeal the 1993 ACC rate order and  
6 reduce imputation to \$43 million, was the Company content to leave imputation at  
7 the negotiated \$43 million level in its 1999 rate filing?

8 A. No. In its very next rate case in 1999, the Company advocated reduction of  
9 imputation from the Settlement Agreement level of \$43 million to zero.<sup>23</sup> My  
10 testimony in that Docket explained that a more equitable imputation for ratepayers  
11 would be no less than \$93.1 million,<sup>24</sup> but in deference to the 1988 Settlement  
12 Agreement, Staff advocated only \$43 million be included in determining revenue  
13 requirements. The 1988 Settlement Agreement has consistently understated the  
14 amount of imputation that customers should have received, given the substantial  
15 growth in the value of the official directory publishing rights within the USWC/QC  
16 ILEC service territory.  
17

18 Q. Has Qwest offered any firm commitment to continue imputation at the \$43 million  
19 level after Dex is sold in the pending transactions?

20 A. No. After arguing that the ACC has no jurisdiction over this transaction because of  
21 the Settlement Agreement at pages 10 and 11 of her testimony, Ms. Arnold  
22 concludes her Direct Testimony at page 20 with the statement, "Finally, the 1988  
23 Settlement Agreement ensures that this transaction will not impact QC rates, and  
24 provides for continued imputation to the benefit of ratepayers." However, the

---

23 Docket No. T-1051B-99-105, Testimony of Anne Koehler-Christensen, pages 1 through 15.

24 ACC Docket No. T-1051B-99-105, Direct Testimony of Brosch, page 48.

1 Company's own interpretation of the Settlement Agreement in the 1999 rate case  
2 did not "provide for continued imputation" while Dex was under common ownership.  
3 It is difficult to place much faith in the 1988 Settlement Agreement to "ensure"  
4 anything about future imputation, since the Company has already argued that no  
5 imputation is required under the same agreement. It should be noted that Qwest's  
6 witnesses offer no firm commitment to impute \$43 million or any other value in  
7 future QC rate cases in Arizona.

8  
9 Q. Was a long-term Noncompetition Agreement granted by Mountain Bell in favor of  
10 the new publishing affiliate in 1984, as part of the disputed asset transfer that was  
11 ultimately resolved in the 1988 Settlement Agreement?

12 A. No. In stark contrast to the divestiture era transfer of tangible directory publishing  
13 assets, the pending transaction to sell Dex involves a long-term Noncompetition  
14 Agreement. Through this Agreement, QC will surrender its right to re-enter the  
15 publishing business or to negotiate a publishing fee from another publisher in return  
16 for the grant of the "official publisher" privilege for a period of 50 years. The  
17 existence of such a covenant indicates how different the pending transaction is to  
18 the shuffling of assets and personnel among affiliates that was reluctantly accepted  
19 by the Commission in the 1988 Settlement Agreement. In 1984, Mountain Bell was  
20 not contractually precluded from re-entering the directory publishing business or  
21 demanding even larger publishing fees for the value of the official publisher  
22 designation.

23  
24 Q. At page 10 of her testimony, Ms. Arnold argues that, in the 1988 Settlement  
25 Agreement "...the Commission accepted as valid the transfer of these directory-  
26 publishing assets from Mountain Bell to UWSD [sic], and agreed to take no further

1 action to challenge that transfer." Did the Commission permanently resolve the  
2 issue of ratepayer entitlement to economic participation in the financial benefits  
3 associated with the directory publishing business in the 1988 Settlement  
4 Agreement?

5 A. No. The 1988 Settlement Agreement resolved issues surrounding an earlier  
6 transfer of certain assets between affiliates that it had previously rejected and was  
7 the subject of litigation. The Settlement Agreement left open for reconsideration the  
8 value of fees and services under affiliate publishing arrangements that might justify  
9 adjustments to a presumed reasonable imputation value fixed at \$43 million per  
10 year.

11  
12 Q. At page 10 of her testimony, Ms. Arnold states, "As I indicated, in the Settlement  
13 Agreement the Commission accepted as valid the transfer of these directory-  
14 publishing assets from Mountain Bell to UWSD [sic], and agreed to take no further  
15 action to challenge that transfer. This means that, upon the Commission's approval  
16 of the Settlement Agreement in June 1988, these directory publishing assets were  
17 no longer the assets of Mountain Bell, QC's predecessor and the regulated service  
18 corporation at that time." Are the "assets" being described by Ms. Arnold the  
19 primary assets now being conveyed to the Buyer of the Dex business?

20 A. No. The Mountain Bell directory publishing assets in Arizona that were transferred  
21 as of January 1, 1984 included \$56.3 million in cash and \$8.3 million of fixed assets  
22 including a building, PBX, motor vehicles, furniture and computers, less \$2.0 million  
23 in accounts payable assumed by the affiliate.<sup>25</sup>

24 The cash balance transferred to the publishing affiliate 20 years ago cannot  
25 be sourced into the present transaction, because cash assets of Dex are retained

---

25 Qwest response to STF 4-156.

1 by the seller.<sup>26</sup> The book value of all other tangible assets being transferred to the  
2 Buyer represent only (START CONFIDENTIAL) [REDACTED], (END CONFIDENTIAL)  
3 which is less than (START CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL) percent of  
4 the total purchase price, as shown at Exhibit MLB-1, line 2. Thus, it is unlikely that  
5 any of the tangible directory assets that were transferred out of Mountain Bell in late  
6 1983 are significant to the Dex business being sold 20 years later. The more  
7 important elements of value now being sold are the intangible assets associated  
8 with the ILEC official publishing rights, the goodwill and going concern value of the  
9 business and its customer relationships, the long-term Noncompetition Agreement  
10 and the Qwest Dex trade names and marks.  
11

12 Q. Were any of these intangible assets sold by Mountain Bell to USWD in 1983 when  
13 the tangible physical directory assets were transferred?

14 A. No. There was no sale or permanent transfer of intangible assets associated with  
15 the right to serve as official publisher. Instead, the Publishing Agreements  
16 commencing in 1984 conveyed a right to use these intangible assets during the  
17 term of the Agreements, in effect renting them as part of the official publisher status  
18 that was granted to USWD. The problem with the previous Publishing Agreements  
19 was the failure to adequately compensate the telephone company for the valuable  
20 official publisher status. Similarly, the new Publishing Agreement with the Buyer of  
21 Dex grants the official publisher franchise associated with the Qwest Corporation  
22 ILEC Dex territory, again with no ongoing compensation to the telephone company  
23 for the value of that franchise. The only reasonable conclusion to be drawn from  
24 these facts is that the \$7.05 billion sale price of the business, less the relatively

---

26 Rodney Contribution Agreement (Exhibit B) at Schedule 2.2 lists "excluded assets" and numbered item 4.  
therein is "Cash and cash equivalents".

1 modest amount of tangible assets contributed by the Seller, represents the overall  
2 present value of fees and services being conveyed in the transaction pursuant to  
3 the commercial agreements.  
4

5 Q. In the event the Commission does not agree with you and instead decides to apply  
6 the principles within the 1988 Settlement Agreement to the pending transaction,  
7 should the \$43 million in imputation be adjusted to reflect the value of fees and  
8 services associated with the Dex sale transaction?

9 A. If the 1988 Settlement Agreement were deemed applicable to the pending Dex sale,  
10 the \$43 million imputation value should be increased significantly and made  
11 permanent at a new higher level reflective of the value of fees and services within  
12 the new Publishing, Noncompetition and other commercial agreements to be made  
13 effective between QC and the Buyer of Dex. The "value of fees and services"  
14 principle embedded within the Settlement Agreement can be employed to observe  
15 that the \$43 million level of imputation is woefully inadequate relative to the value  
16 actually being paid for Dex and its exclusive ongoing "official publisher" relationship  
17 with the regulated telephone company.  
18

19 **Ratepayers Retain a Valid Claim Upon Dex**

20 Q. Has Qwest offered any analysis to support its apparent conclusion that  
21 shareholders, rather than ratepayers, are entitled to retain the multi-billion dollar  
22 gain to be realized as a result of selling Dex?

23 A. No. The directory business of Qwest (and its predecessors) in Arizona has  
24 consistently been operated in coordination with the regulated telephone operations  
25 under common ownership, so as to capture the tremendous economic benefits of  
26 publishing directories in conjunction with (and as an offset to the costs of) providing

1 telephone services. Like the other regional Bell holding companies, directory  
2 publishing grew up within the telephone business because the Bell companies were  
3 recognized by advertisers as publishers of the most complete "official" directories in  
4 their territories. In this section of my testimony, I will explain the synergies and  
5 linkages between the telephone company and the publisher of official directories for  
6 the telephone company that caused Dex business revenues and profits to be  
7 imputed by this and other regulatory commissions.  
8

9 Q. In your opinion, are Dex directory operations integrally linked to the provision of  
10 local phone services, such that directory publishing income is rightfully credited or  
11 imputed into the telephone company's revenue requirements?

12 A. Yes. The linkages between the white and yellow page directories of Dex and the  
13 telephone services of Qwest Corporation continue to include:

- 14 1) Listings that represent the primary information content of the  
15 directories are created in operation of the local phone  
16 business. This makes the telephone company the best source  
17 for the most current and complete listings information. To  
18 advertise in the Dex yellow pages you must have business  
19 telephone service.<sup>27</sup>  
20
- 21 2) Usage of the white and yellow pages is driven by telephone  
22 customers' desire to make more effective use of local  
23 telephone services to reach businesses they wish to  
24 communicate with.  
25
- 26 3) The usefulness of local telephone service is enhanced by the  
27 availability of both alphabetical and classified directories.  
28
- 29 4) In the case of Dex directories, much of the revenues earned  
30 from yellow pages advertising are billed on local phone bills of

---

27 Per Qwest web site description of Qwest Dex yellow page advertising. See  
[http://www.qwest.com/pcat/large\\_business/product/1,1354,55\\_4\\_24,00.html](http://www.qwest.com/pcat/large_business/product/1,1354,55_4_24,00.html)

1 QC telephone customers and are collected and processed by  
2 QC remittance centers.  
3

4 5) Qwest payphones, even though now deregulated, have been  
5 contracted to be provided with Dex directories. This advances  
6 the public perception that Qwest Dex directories are part of the  
7 ILEC services and are the official directories.  
8

9 6) Directories of telephone affiliates are published with prominent  
10 placement of identifying tradenames and trademarks linking  
11 them to the telephone company.  
12

13 7) The public is likely to perceive Dex directories to be endorsed  
14 by the telephone company and thereby the "official" book that  
15 is accurate, current and comprehensive with respect to the  
16 phone number listings controlled and assigned by Qwest.  
17 (See point 1)  
18

19 8) Qwest refers customer inquiries regarding directory advertising  
20 to Dex, where such referrals may lead to incremental sales of  
21 advertising.  
22

23  
24 Simply stated, Dex publishes the "official" phone books for Qwest, and these  
25 directories offer significant value to advertisers as well as supra-competitive profits  
26 to the publisher. For all of these reasons, the traditional regulatory practice for  
27 many years, as codified in the FCC's Uniform System of Accounts and recognized  
28 by this Commission for many years, is to treat directory advertising and other  
29 directory publishing revenues as above-the-line for ratemaking purposes.<sup>28</sup>  
30

---

28 As noted in prior testimony, the amount of directory publishing revenues to be treated above-the-line in Arizona has continued to be a contentious issue, even though ostensibly resolved by the 1988 Settlement Agreement.

1 Q. Many of the linkages between the telephone company and the directory operations  
2 that you describe appear to represent intangible goodwill assets enjoyed by the  
3 publisher from its relationship with the telephone company. Is this goodwill value  
4 recognized anywhere on the books of Dex or the telephone company?

5 A. No. Going concern or goodwill is not an investment that required contributions of  
6 cash or other assets by Qwest or QCI, but instead this value has arisen from doing  
7 business successfully over a period of time. For this reason, there are no recorded  
8 goodwill assets on the Dex or QC balance sheet associated with this value. In the  
9 pending transaction, \$7.05 billion is being paid to acquire the Dex going concern  
10 business, its goodwill, and its consistently large income stream. The origin of this  
11 goodwill and income stream arises from linkages into the telephone company that  
12 have existed for decades, linkages that are carefully preserved in the many  
13 commercial agreements that are made a part of the transaction.  
14

15 Q. Is the relationship between QC and Dex unique, or do the other three regional "Bell"  
16 holding companies also publish telephone directories that tend to be more profitable  
17 than the directory operations of non-ILECs?

18 A. According to information contained in a confidential Qwest Dex Strategy White  
19 Paper provided in response to Staff Data Request No. 2-84 at page 5, the Regional  
20 Bell Operating Companies ("RBOCs") have very attractive revenue and Earnings  
21 Before Interest, Taxes, Depreciation and Amortization ("EBITDA") characteristics:

22 (START CONFIDENTIAL)   
23  
24  
25  
26  
27  
28

1 [REDACTED]  
2 [REDACTED]  
3 [REDACTED]  
4 [REDACTED]  
5 [REDACTED]

6 [REDACTED]  
7 [REDACTED]  
8 [REDACTED]  
9 [REDACTED]  
10 [REDACTED]  
11 [REDACTED]  
12 [REDACTED]  
13 [REDACTED]  
14 [REDACTED] (END CONFIDENTIAL).  
15 [REDACTED]

16 These comments indicate RBOC market dominance and the distinctively higher  
17 earnings margins and cash flows realized by the incumbent local Bell company  
18 publishers, relative to the lower-margin competitors' financial performance. Such  
19 market dominance and financial performance among the RBOC publishers, relative  
20 to non-RBOC competitors, is indicative of the strategic advantages derived by  
21 linkages to the telephone operation and the benefits of official publisher status.  
22

23 Q. Have Dex revenues, operating profits and cash flow trends continued to improve in  
24 the past few years?

25 A. Yes. According to the Dex Confidential Descriptive Memoranda prepared to  
26 describe the Dex business in soliciting bids from potential acquirers, the recent  
27 year's unaudited actual and projected Dex revenue and EBITDA values were:  
28  
29  
30  
31

(START CONFIDENTIAL TABLE)

Confidential	Consolidated Dex Financial Information (\$millions)							
	1999	2000	2001	2002Est	2003Est	2004Est	2005Est	2006Est
Dex Total Revenues								
EBITDA								

Source: STF 1-26S1, Attachment A, pages 37 and 49.

(END CONFIDENTIAL TABLE)

Q. Do the linkages between the telephone company and the publishing affiliate justify the continued imputation of directory revenues into QC income for ratemaking purposes?

A. Yes. Imputation of revenues from the directory publishing affiliate has been necessary historically when setting rates because these revenues are created in large part from the unique benefits of affiliation with Qwest's telephone business, benefits that arise from and are integrally related to the provision of local telephone services. Upon sale of the Dex business, the ongoing earnings stream reflective of the linkages is to be transferred, but the Commission can now consider the fair market value of the directory operations business and determine the final financial adjustments and any other conditions needed to properly attribute this value to ratepayers.

Q. Earlier in your testimony, in describing the pending Dex sale transaction, you stated, "The commercial agreements are required to convey the full value of the business to the Buyers". Do the commercial agreements serve the purpose of preserving the linkages between Qwest Corporation's ILEC telephone business and the directory publishing business, after Dex is no longer an affiliate of Qwest Corporation?

1 A. Yes. The unique benefits of affiliation between QC and Dex, that were assured in  
2 the past through common corporate ownership and control, are now carefully  
3 formalized within the commercial agreements that are incorporated into the Dex  
4 sale contracts.

5  
6 Q. How does the new Publishing Agreement between Dex Holdings L.L.C. and Qwest  
7 Corporation preserve the benefits of linkages between the regulated telephone  
8 company and the directory publisher?

9 A. The new Publishing Agreement designates the Buyer as Qwest Corporation's  
10 exclusive official publisher of all Directory Products in its region for a 50 year period,  
11 with certain Qwest Dex "branding rights" and a right to any referrals QC makes  
12 concerning directory advertising. (Exhibit D at 4.2).

13  
14 Q. Have the parties to the Dex sale agreement also made provision for the continued  
15 use of Qwest Dex intangible assets, so as to maintain the identity of the buyer as  
16 the publisher of the "official publisher" of Qwest's directories?

17 A. Yes. The new Trademark License Agreement grants the Buyer the right for five  
18 years to use the "Qwest Dex" trademark on its products within the directory  
19 publishing service area, to provide continuity in the public identity of the business.  
20 (Exhibit J at 2.1).

21  
22 Q. Earlier in your testimony, you mentioned the new Noncompetition Agreement that  
23 was negotiated to protect the Buyer against Qwest Corporation's potential re-entry  
24 into the lucrative RBOC directory publishing business. How does this agreement  
25 work?

1 A. The new Non-Competition and Non-Solicitation Agreement serves to prevent Qwest  
2 from marketing, selling or distributing Directory Products in the Dex region in  
3 competition with the Buyer within the 40-year term of the Agreement. Qwest also  
4 agrees to not solicit for hire any employees or management transferred to the Buyer  
5 for a period of two years. (Exhibit M at 3.1, 4).  
6

7 Q. Is this Agreement intended to be binding upon Qwest Corporation ("QC"), the entity  
8 regulated by the Commission?

9 A. Yes. Qwest Corporation is listed as one of the "Qwest Parties" in the preamble of  
10 Exhibit M that are subject to the restrictions precluding in-region publishing of  
11 listings and advertising. However, even though QC surrenders its right to publish  
12 white and yellow pages directories in Arizona and other local exchange areas it  
13 served for 40 years, Qwest Corporation is not the owner or seller of Dex and will not  
14 receive any of the proceeds from the sale of Dex. The Noncompetition Agreement  
15 recognizes and eliminates the risk to the Buyer that QC might choose to re-enter the  
16 directory publishing business as a formidable competitor because of the many  
17 advantages enjoyed by RBOC official directory publishers.  
18

19 Q. Has provision also been made within the commercial agreements between Buyer  
20 and Seller for a continuation of billing and collection services by QC, for the benefit  
21 of the new owner of Dex?

22 A. Yes. A new Billing and Collection Services Agreement allows the Buyer to receive  
23 billing and collection services from Qwest Corporation, services not received by any  
24 other directory publisher. The linkage between the telephone company and the Dex  
25 business is reinforced by providing many Dex advertising customers with a  
26 combined bill that also reflects the customer's Qwest Corporation telephone service

1 charges. Creation of the combined end-user bill creates an accounts receivable  
2 balance for advertising as well as telecommunications services.<sup>29</sup>

3  
4 Q. Will Dex continue to be the supplier of directories for QC payphones throughout  
5 Arizona and the other states served by QC?

6 A. Yes. A new Public Pay Stations Agreement provides for the continued placement of  
7 Dex directories within Qwest Corporation's payphones. (Exhibit I)

8  
9 Q. You previously mentioned the extraordinary profitability and cash flow realized by  
10 RBOC-affiliate directory publishers like Dex. Will the Buyer of the Dex business  
11 receive and employ the human resources, automated systems, customer  
12 information and management personnel required to maintain business continuity  
13 and profitability?

14 A. Yes. Under the Rodney Purchase Agreement and the related Exhibit B Contribution  
15 Agreement, all of the existing tangible and intangible assets, allocated employees,  
16 designated management personnel and customer data of Dex that is related to the  
17 Rodney business will be transferred and sold to the Buyers. Thus, the Buyer  
18 receives the full going concern business at closing and is assured of no diminution  
19 of that value because of the protections built into the various other commercial  
20 agreements described above.

21  
22 Q. After the Rodney Purchase Agreement and all of the incorporated commercial  
23 agreements are made effective, will the resulting complete and permanent

---

29 Qwest Corporation has also agreed to (START CONFIDENTIAL) [REDACTED]  
[REDACTED] (END CONFIDENTIAL) to the confidential  
Agreement for the Provision of Billing and Collection Services, identified as Exhibit G to the Rodney Sale  
Agreement.

1 liquidation of the Dex directory publishing business preclude any future  
2 consideration by the Commission of changes in the value of fees and services  
3 associated with the directory publishing business?

4 A. Yes. QCI is left with only cash proceeds until applied to debt repayment, and with  
5 no further opportunity to publish directories on its own behalf. The operational and  
6 financial details of directory publishing within Arizona will no longer be accessible  
7 through an affiliated Qwest entity.

8 **Risks to Customers Created by the Sale of Dex**

9 Q. What are the risks to customers and regulatory issues that are created by the  
10 pending Dex sale?

11 A. The sale of Dex creates substantial new risks and issues to be addressed by the  
12 Commission:

- 13 • The liquidation of the directory business terminates the 1988  
14 Settlement Agreement that historically governed the affiliate  
15 relationship between QC and Dex, creating uncertainty about how  
16 directory imputation is to be quantified or adjusted in the future.  
17
- 18 • The sale of Dex to a non-affiliated Buyer will cause regulators to lose  
19 access to directory publishing financial and operational information  
20 that is needed to evaluate the value of fees and services for  
21 consideration within telephone company financial reporting and to  
22 determine revenue requirements.  
23
- 24 • Sale of the Dex income stream also substantially reduces the long-  
25 term ability of the Qwest consolidated businesses to generate cash  
26 flow from operations needed to service debt and attract capital on  
27 reasonable terms.  
28
- 29 • Sale of Dex provides a market valuation for the directory publishing  
30 regulatory asset and a corresponding gain on sale that must be  
31 attributed either to shareholders or ratepayers. Qwest's witnesses

1 suggest that none of the gain should be attributed to telephone  
2 customers.

- 3
- 4 • Sale of Dex will cause the actual production and distribution of  
5 directories to be performed by a non-affiliated entity for the first time in  
6 Company history. The sale potentially reduces the Commission's  
7 ability to regulate Qwest's directory publishing obligation to  
8 customers.
  - 9
  - 10 • Sale of Dex will likely increase corporate shared costs to be borne by  
11 QC.
  - 12

13 Q. Please explain the risks created when the directory business is no longer available  
14 for imputation in any future proceedings in which the Commission may be  
15 concerned with Qwest's Arizona intrastate earnings and financial condition?

16 A. The future earnings and cash flows of Dex are being sold by Qwest to improve  
17 liquidity and satisfy the near-term demands of creditors. As a result, there will not  
18 be any affiliate publisher directory revenues to impute and no corporate accounting  
19 information from which to determine the value of fees and services from the Dex  
20 business that continues to operate in Arizona under new ownership. The sale of the  
21 income stream and the absence of Dex financial data creates risk that future  
22 imputation will be impossible to quantify or justify with factual data. For the first time  
23 in the Company's history, Dex is the subject of a true sales transaction that will  
24 permanently transfer all of the tangible property, employees, customers and specific  
25 intangible assets that are required to install the buyer as official publisher for the  
26 next 50 years.

27

28 Q. Is the financial condition of Qwest Corporation and its parent QCI of vital importance  
29 to the Commission, even if price cap regulation continues in Arizona?

1 A. Yes. The Company must continue to have access to capital on reasonable terms to  
2 provide high quality regulated services. A major segment of Qwest's business that  
3 has been extremely profitable for many years is being liquidated to satisfy creditors'  
4 demands over the next few years. However, by the Company's own consolidated  
5 projections of cash flows with the complete sale of Dex within this year, the ability to  
6 (START CONFIDENTIAL) [REDACTED]  
7 [REDACTED] (END CONFIDENTIAL).<sup>30</sup> In a very real sense, the sale of Dex  
8 appears to be a corporate survival tactic that compromises the long-term strength of  
9 the business in an attempt to increase liquidity and meet near-term debt repayment  
10 obligations. Qwest's significant financial problems were not caused by financial  
11 failures within the regulated business, yet a source of financial support to the  
12 regulated business is being liquidated in an effort to remedy Qwest's liquidity crisis.  
13

14 Q. Do you agree with the testimony of Qwest witness Mr. Brian Johnson that the sale  
15 of Dex is important to the continued financial viability of QC and the parent company  
16 QCI?<sup>31</sup>

17 A. Yes. Mr. Johnson and Mr. Cummings describe in some detail the deterioration in  
18 Qwest's consolidated financial performance, credit rating downgrades to junk status,  
19 accounting investigations and Qwest's resulting liquidity crisis. While it may have  
20 been possible for Qwest to sell assets or business segments other than Dex, issue  
21 new securities at extremely high cost or reorganize the business through a merger,  
22 the sale of Dex was an attractive option for several reasons. Dex is an attractive  
23 business segment to sell because of its enviable market position, robust cash flows  
24 and financial strength and will therefore yield cash proceeds upon sale that are

---

30 See Highly Confidential financial projections in STF 2-115S1.  
31 Brian G. Johnson Direct Testimony, page 13.

1 large enough to measurably improve Qwest's financial condition by reducing debt  
2 leverage. Notably, the Dex sale is larger, but similar to other directory sale  
3 transactions recently announced by Sprint, McLeod USA and Bell Canada to  
4 improve liquidity and access to capital markets.<sup>32</sup>

5  
6 Q. Should the financial viability of Qwest and the desire of QCI to de-lever its balance  
7 sheet prevent the Commission from considering the interests of ratepayers in the  
8 Dex business and the proper distribution of the gain being realized from the sale?

9 A. No. In my opinion the interests of ratepayers in the Dex business are not  
10 subordinate to the interests of shareholders in preserving the gain and cash  
11 proceeds for corporate purposes. A reasonable attribution of the gain to Arizona  
12 customers is necessary to secure increased imputation levels (or an economic  
13 substitute for such imputation) and ensure that the sale of Dex is consistent with the  
14 public interest. It remains possible that Qwest will not survive its liquidity crisis even  
15 with the sale of Dex. If a Qwest bankruptcy eventually occurs, there may then be  
16 less of an opportunity to be sure that customers' interests in the Dex business are  
17 safeguarded.

18  
19 Q. Does the Rodney Agreement explicitly recognize and provide for regulatory impacts  
20 that may be imposed by this Commission and by other state commissions?

21 A. Yes. At paragraph 5.4(b)(ii), the Rodney Agreement allows Qwest to not close the  
22 Rodney phase of the Dex sale in the event regulatory conditions imposed by states,  
23 including net revenue reductions or mandated incremental capital expenditures,

---

32 Sprint agreed to sell its directory business to R.H. Donnelley Corp for \$2.23 billion in cash, as announced in September 2002. McLeodUSA Publishing was sold to U.K.-based Yell Group for \$600 million in a deal announced in January 2002. The Bell Canada Directories business was sold for \$3 billion in cash (Canadian) to KKR and the Teachers' Merchant Bank in a deal announced in September 2002.

1 become large enough to qualify as a "material regulatory impact" or "MRI". A  
2 separate "confidential letter of understanding" defines the MRI threshold to be  
3 (START CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL).<sup>33</sup> Thus, Qwest can  
4 terminate its obligations under the Rodney agreement if net economic losses from  
5 regulatory conditions reach this threshold value. Qwest's confidential Seller's  
6 Disclosure Schedule at Section 3.4 identifies (START CONFIDENTIAL) [REDACTED]  
7 [REDACTED]  
8 [REDACTED]  
9 [REDACTED] (END  
10 CONFIDENTIAL).

11  
12 Q. Has Qwest assumed any MRI reduction will occur within its financial projections  
13 contained in the highly confidential response to STF 2-115S1?

14 A. (START CONFIDENTIAL) [REDACTED]  
15 [REDACTED] (END CONFIDENTIAL) to the cash proceeds from the Rodney transaction  
16 are assumed in the year 2003, when Rodney is projected to close. In addition, the  
17 projections also appear to assume (START CONFIDENTIAL) [REDACTED]  
18 [REDACTED] (END CONFIDENTIAL) to the Buyers  
19 pursuant to the Rodney Agreement.<sup>34</sup> Thus, the cash proceeds ultimately available  
20 to the Company for debt repayment are uncertain, depending upon the magnitude  
21 of regulatory demands on behalf of ratepayers as well as the extent to which Qwest  
22 contributes seller financing to the transaction.

---

33 See MRI Side Letter captioned, "Confidential Letter of Understanding".

34 In its response to Data Request STF 2-114, the Company stated, "The Buyer has orally informed Qwest that it will need up to \$117 million of equity in addition to amounts committed by others in the Rodney Equity Financing Commitment Letter. Qwest has the option of funding that equity to ensure closure of the transaction. However, Qwest expects that the buyer will cover that amount itself or will arrange for other third parties to cover it...At this point, it is too early to speculate on a final result. Decisions relating to whether Qwest will ultimately

1  
2 Q. Please explain how the sale of Dex can be expected to increase corporate shared  
3 costs to be borne by QC.

4 A. Qwest incurs certain corporate overhead costs related to its corporate executive  
5 management, finance and accounting, treasury, human resources, marketing and  
6 other centralized administrative functions. These costs have historically been  
7 pooled and assigned or allocated across the various Qwest subsidiary operations,  
8 including QC and Dex, with Dex receiving a substantial portion of such charges.<sup>35</sup>  
9 Upon sale of Dex, for a limited transition period of 18 months after closing, some of  
10 these centralized corporation service functions will be provided to the Buyer  
11 pursuant to a Transitional Services Contract.<sup>36</sup> However, this contract may not fully  
12 offset the additional cost burden upon QC when Dex is no longer a corporate  
13 affiliate receiving a full allocated share of corporate administrative overhead costs.  
14 After the 18-month term of the Transition Services Agreement, corporate shared  
15 costs that cannot be reduced after Dex is sold will necessarily be absorbed by  
16 allocation across the remaining affiliates including QC's regulated business. In an  
17 effort to evaluate this concern, Staff submitted Data Request STF 2-83 asking for "a  
18 calculation of the expected annual impact upon Qwest Corporation's Arizona-  
19 intrastate charges from affiliates as a direct result of Qwest Dex being sold and no  
20 longer receiving its allocated share of such affiliate charges", to which the Company  
21 replied, "Qwest has not prepared the requested calculation. Preparation of the  
22 requested information would require a special study".

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contribute any equity will be made as the Rodney closing nears in 2003."

35 According to Qwest's confidential response to Data Request STF 2-82, Attachment A, Qwest Services Corporation headquarters cost allocations to Dex have ranged from (START CONFIDENTIAL) (END CONFIDENTIAL) million in the years 1999, 2000 and 2001, information technologies affiliate charges were more than (START CONFIDENTIAL) (END CONFIDENTIAL) million in 2001, and significant other legal, property administration and other affiliate charges were attributed to Dex.

Beyond the effect of more narrowly allocated shared corporate costs, another cost increase to be imposed by the sale of Dex relates to the commitment by the Qwest parties to purchase on a take or pay basis at least (START CONFIDENTIAL) \$ (END CONFIDENTIAL) per year in directory advertising from Dex for each of the next 15 years after the sale.<sup>37</sup>

### **Recommended Conditions Upon Approval**

Q. What is your recommendation regarding the Dex transaction in Arizona?

A. If not for the acute financial condition of Qwest and the possibility that selling Dex may allow the Company to survive its financial crisis, I would recommend that the Commission reject the sale of the directory publishing business. However, given the present economic circumstances of Qwest as well as the risks created by the transaction, I recommend approval of the Dex sale, subject to imposition of the following specific conditions by the Commission:

1) The 1988 Settlement Agreement should be found not applicable to ongoing transactions with the Buyer of Dex. In place of the fixed, \$43 million imputation in that Settlement, the Arizona share of the gain should be used to provide for an updated annual revenue credit in lieu of imputation. If price cap regulation is continued in Arizona, a condition of sale approval should be an annual credit of \$100 million of directory revenues to telephone company operations in all future financial reporting, earnings investigations and other filings prepared for submission to the Commission in all future periods. Alternatively, if price cap regulation is terminated and traditional regulation is resumed, an annual credit of \$121.3 million should be ordered for each of the next 20 years.

2) In the event the \$43 million imputation is not increased in accordance with recommendation 1, above, the remaining Arizona share of the gain after accounting for the ongoing \$43 million imputation, should

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36 Exhibit K to the Rodney/Dexter Agreements is a Transition Services Agreement.  
37 This is referred to as the "Annual Ad Commitment" in Exhibit A to the Rodney Agreement.

1 be flowed to QC's Arizona customers on a one-time basis, through a  
2 customer bill credit. If the recommended updated imputation value in  
3 item (1) is approved, no customer bill credits will be necessary.  
4 However, if annual imputation is retained at the \$43 million annual  
5 level and price cap regulation continues, the bill credit amount set  
6 forth in Exhibit MLB-1 at line 26 of \$593 million would be required to  
7 fully credit customers for the Arizona share of the value of fees and  
8 services being realized by Qwest. The comparable value under future  
9 traditional regulation is \$671.5 million.

10  
11 3) In the event the Commission determines that specific network  
12 investment commitments or desirable service quality improvement  
13 programs that require financial commitments by QC would not  
14 otherwise occur, these initiatives could be funded with a portion of the  
15 remaining Arizona share identified in item 2, above. Any dedication of  
16 ratepayer funds in this manner should be subject to rigorous reporting  
17 and regulatory monitoring with administration through discrete  
18 regulatory liability accounts on QC books.

19  
20 4) Informational disclosures within the Arizona directories of Dex should  
21 be expanded to include Spanish and English language tariff  
22 information, consistent with correspondence between the Commission  
23 and the QC President of Arizona operations dated December 19,  
24 2002.  
25

26 These measures will ensure that Arizona customers are not adversely impacted by  
27 ceasing imputation and raising future rates, while also ensuring that the Arizona  
28 portion of the economic value of the Dex business enterprise is attributed to  
29 customers, rather than shareholders. Since most of the Arizona share of the Dex  
30 gain on sale proceeds would be retained by Qwest to fund the increased imputation  
31 liability to customers under Staff's primary recommendation, the vast majority of  
32 cash is immediately available to reduce corporate debt. The amounts set forth in  
33 the Staff's recommendations are explained in the following section of testimony.

**Gain on Sale Allocation to Arizona**

Q. Was the Company asked to provide a calculation of the gain on sale anticipated to be realized from the Dex sale transaction?

A. Yes. Data Request STF 2-68 requested information about the book and tax basis of the business interest to be sold and detailed calculations of the estimated book and tax gain on sale to be realized by QCI as a result of each (Dexter/Rodney) transaction, with supporting workpaper calculations, assumptions and underlying source documents. The Company provided a narrative response stating:

An accurate estimation of the book and tax basis for the Dex business interest to be sold and the final sales price remains impracticable at this time. However, Qwest has now prepared a preliminary estimate of the gain on the sale of Dex and a computation of the portion of that estimated gain related to Arizona. Qwest's preliminary estimate is provided in Confidential Attachment "A".

The gain estimate assumes a sales price of \$7.05 billion. The actual sales price will not be known until after computation of the Post-closing Working Capital Purchase Price Adjustment set out in Paragraph 2.9 of the Rodney Purchase Agreement and the Buyer's and Seller's agreement on that adjustment.

This preliminary gain calculation relies on estimates of net book value and transaction costs. Neither the actual net book value at closing nor the actual transaction costs will be known until after closing.

I utilize the Company's estimated gain calculation on confidential "Attachment A" from this response as the starting point for information set forth in my Confidential Exhibit MLB-1 and have included each step of the Company's estimated Arizona gain calculation (column B) for comparison to the Staff's recommended calculations (column C). In this way, each disagreement or potential issue regarding the gain calculation and allocation to Arizona is highlighted for consideration by the Commission.

1 Q. Did Qwest provide each of the estimated values shown at lines 1 through 4 of  
2 Confidential Exhibit MLB-1 in its response to Data Request STF 2-68?

3 A. Yes. The sale price of \$7.05 billion is the combined Dexter and Rodney price  
4 according to the Purchase Agreements, assuming no working capital adjustments  
5 are ultimately applied to this value. The (START CONFIDENTIAL) [REDACTED]  
6 [REDACTED] (END CONFIDENTIAL) is approximately  
7 equal to the total assets of Dex Holdings as of December 31, 2001 and contains  
8 mostly current assets that will be subject to the purchase price true-up provisions  
9 referenced above.<sup>38</sup> The "transaction costs" subtracted from sale proceeds at line 3  
10 include estimates of the total fees payable to investment bankers, legal and other  
11 advisory personnel involved in the transaction.<sup>39</sup> As noted in Confidential Exhibit  
12 MLB-1, Staff has not challenged any of the Company's estimates regarding  
13 purchase price, contributed assets or transaction costs.  
14

15 Q. Is the \$7.05 billion purchase price negotiated between the Buyer and QCI  
16 representative of full, fair market value for the Dex business?

17 A. The increasingly urgent financial difficulties facing Qwest were widely known at the  
18 time the Company was soliciting interest in the purchase of the Dex business. In  
19 addition, the large size of the business and the Company's need for cash  
20 consideration tended to limit the number of potential buyers in a position to finance  
21 such a transaction. These factors detracted from Qwest's ability to get top dollar for  
22 Dex and (START CONFIDENTIAL) [REDACTED]

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38 The Company's confidential response to Data Request STF 2-55, Attachment B, provided restated financial statements for Qwest Dex Holdings, Inc. indicating total assets of (START CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL) at 12/31/2001.

39 In response to Data Request STF 2-60, the Company itemized actual transaction costs payable through September 30, 2002 that totaled \$3.7 million. However, large amounts payable pursuant to engagement letters with Lehman Brothers and Merrill Lynch are not due until closing.

1 [REDACTED] (END CONFIDENTIAL).<sup>40</sup> In  
2 the "fairness opinions" prepared for Qwest by Merrill, Lynch and Lehman Brothers,  
3 the \$7.05 billion negotiated price for Dex is near (START CONFIDENTIAL) [REDACTED]  
4 [REDACTED]  
5 [REDACTED] (END CONFIDENTIAL)<sup>41</sup>. From this information, it is  
6 reasonable to conclude that the negotiated purchase price for the Dex business is  
7 just barely adequate to be considered fair to Qwest's shareholders and customers.  
8 Nevertheless, to be conservative in my recommended ratemaking conditions for  
9 approval of the transaction, I have not contested or adjusted the \$7.05 billion  
10 purchase price.  
11

12 Q. At line 5 of Confidential Exhibit MLB-1, you have reduced the Dex sale proceeds by  
13 almost (START CONFIDENTIAL) [REDACTED] billion (END CONFIDENTIAL) for income  
14 taxes at a 39.53 percent composite tax rate. Will QCI pay any income taxes on the  
15 Dex sale gain it experiences?

16 A. Probably not. As mentioned in my earlier testimony, QCI has accumulated large net  
17 operating loss ("NOL") carryforward balances for income tax purposes. In addition,  
18 the [REDACTED] was included by Qwest in the assets being acquired by the  
19 purchaser for the apparent purpose of reducing income taxes otherwise payable on  
20 the transaction.<sup>42</sup> However, because the sources of negative consolidated taxable  
21 income in past years giving rise to the NOLs and the tax circumstances of the LCI

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28 Confidential response to Data Request STF 2-58, Attachment A, page 7, (START CONFIDENTIAL),  
[REDACTED]

(END CONFIDENTIAL).

41 Confidential response to Data Request STF 2-58, Attachment C, Lehman Brothers at page 13 and  
Attachment E, Merrill Lynch at page 14.

42 Refer to footnote number 12 and the response to Data Request STF 2-118 indicating Qwest's consolidated  
Federal NOL position at \$5.82 billion as of 12/31/2001.

1 entity are not related to the business operations of either the QC regulated  
2 telephone business or Dex, I have attributed Qwest's shelter from income taxes on  
3 the gain entirely to shareholders. There is no denying that the sale of Dex creates  
4 an opportunity for Qwest to realize these tax benefits as additional cash flow via tax  
5 savings, so shareholders are clearly advantaged by my regulatory calculations that  
6 attribute full statutory income tax rates to the Dex gain, even though such income  
7 taxes will not be payable by the seller. According to the Company's response to  
8 Data Request STF 2-118, "The Company has not finally determined what net  
9 operating losses, if any, will be used to offset any taxable gain resulting from the  
10 Dex sale. The Company has not computed its consolidated taxable income or loss  
11 for the tax year ending December 31, 2002."  
12

13 Q. Please explain the purpose for Lines 7 through 13 of Confidential Exhibit MLB-1.

14 A. These lines disclose four allocations proposed by Qwest that would reduce the Dex  
15 sale transaction and resulting gain to be attributed to the portion of the directory  
16 publishing business that has historically been subject to regulatory jurisdiction or  
17 imputation. Specifically, the Company's confidential preliminary gain calculation  
18 that was provided in response to Data Request STF 2-68 carves out portions of the  
19 sale price and resulting gain for attribution to (START CONFIDENTIAL) [REDACTED]  
20 [REDACTED]  
21 [REDACTED]  
22 [REDACTED] (END CONFIDENTIAL). For each of these  
23 portions of the Dex sale, the Company would attribute the realized Dex sale gain to  
24 shareholders, rather than to the basic printed directory business that has been  
25 recognized in imputation calculations.  
26

1 Q. Does the LCI business have anything to do with directory publishing or Dex?

2 A. Aside from common ownership by Qwest, LCI has nothing to do with Dex or  
3 directory publishing. According to the response to Data Request STF 2-117, "LCI  
4 International owns a limited partnership interest in Qwest N. Limited Partnership.  
5 Qwest N. Limited Partnership leases telecommunications equipment to Qwest  
6 Communications Corporation", which is the long distance and data networking  
7 subsidiary of QCI. Because it is unrelated to Dex and appears to have been  
8 bundled into the Dex sale transaction at Qwest's request to realize certain income  
9 tax advantages available to Qwest,<sup>43</sup> I agree with the Company that the sale  
10 proceeds and gain amounts attributed to LCI should be excluded from my  
11 calculations on Confidential Exhibit MLB-1. However, as noted in Confidential  
12 Exhibit MLB-1, (START CONFIDENTIAL) [REDACTED]

13 [REDACTED]  
14 [REDACTED]  
15 (END CONFIDENTIAL) Therefore, LCI is not at issue in allocation of the Dex gain.  
16

17 Q. The next allocation of Dex sale proceeds and gain shown on Confidential Exhibit  
18 MLB-1 at line 9 is for an "Allocation to New Ventures". What is "New Ventures" and  
19 why is it excluded in allocating the Dex sale gain to the Arizona jurisdiction?

20 A. As implied by the label, New Ventures is the portion of Dex that engages in non-  
21 traditional businesses such as internet directories, direct marketing services and  
22 other activities beyond directory publishing. Historically, these activities were not  
23 included within the core directory publishing division of Dex and were not included in  
24 calculation of imputation by regulators. Therefore, I concur with Qwest's calculation

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43 In response to Data Request STF 3-132, the Company stated, "The LCI business was included in the Dex sale to maximize the net proceeds received by Qwest."

1 of the percentage of the estimated gain on sale of Dex that should be attributed to  
2 the New Ventures business. This percentage was based upon the relative  
3 revenues of the New Ventures activities to total Dex revenues and is likely to  
4 overstate the portion of Dex gain properly attributed to New Ventures because  
5 these non-traditional "ventures" are likely to be less profitable than the established  
6 publishing business. However, to be conservative in Staff's calculations in  
7 Confidential Exhibit MLB-1 and to reduce the number of issues in this proceeding, I  
8 accept the Company's revenue-based allocation to New Ventures at line 9.

9  
10 Q. So far, in describing the line items in the Confidential Exhibit MLB-1 gain allocation  
11 schedule, nothing has appeared in the "Difference At Issue" in column D. However,  
12 when we get to the "Allocation to Secondary Directories" at line 10, you have  
13 completely rejected the Company's treatment. What are secondary directories?

14 A. Secondary directories are discretionary additional phone books produced by Dex  
15 within the QC territory to earn additional advertising revenues. Typically, they  
16 include regional and specialized directories, such as the "On The Go" directories for  
17 use with cellular telephones and in automobiles. In Arizona, the Dex secondary  
18 directories include the Scottsdale, Greater Northwest Valley, Greater Southwest  
19 Valley, East Valley, Mohave County, Phoenix On-the-Go and several Tucson  
20 regional directories, which are additional books marketed to advertising customers  
21 by addressing the value the advertiser receives, considering the circulation of the  
22 directories, the scope of the directories and the quality of the directories.<sup>44</sup>

23  

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44 See Qwest's responses to Data Request STF 2-122S2 and STF 3-140.

1 Q. What is your understanding of the Company's rationale to allocate some of the gain  
2 on the Dex sale to its shareholders, rather than to Arizona customers, because of  
3 the secondary directories that are published by Dex?

4 A. According to the response to Data Request STF 3-128, "Secondary directories are  
5 published at Dex's discretion in order to compete more effectively in the advertising  
6 market and maximize advertising sales by providing directories that allow  
7 advertisers to focus their advertising message to a specific geographic scope which  
8 best represents their customer base." Additional reasoning for the Company's  
9 position is stated in Qwest's evidence in the Dex sale Docket that was recently  
10 concluded in Utah:

11 Secondary directories were not published in all the years that the directory  
12 operations were part of the regulated Mountain Bell operations. While one  
13 could speculate that they might have eventually developed had the transfer  
14 never occurred, the facts are that no Secondary directories were published  
15 when directory publishing was part of the Utah regulated operations.  
16 Secondary directories are not tied to QC's regulatory obligation to provide  
17 Primary directories.<sup>45</sup>  
18

19 Q. Should secondary directories be excluded in allocating the Dex gain on sale to  
20 Arizona?

21 A. No. Secondary directories represent additional products through which the directory  
22 publisher can prudently maximize revenues and profits, by scoping and publishing  
23 additional directories in targeted markets that do not conform strictly to telephone  
24 exchange areas. This is not a new or particularly innovative practice and is not  
25 unique to Dex. Prudent management is reasonably expected to seek growth  
26 opportunities in new markets and leverage recognized brand names like Qwest and  
27 U S West. Indeed, if the telephone company had remained in the directory

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45 Rebuttal Testimony of Ann Koehler-Christensen, filed on February 17, 2003 in PSCU Docket No. 02-049-

1 publishing business after 1983, nothing would have precluded adding secondary  
2 book publications to maximize revenues, so as to reduce the net cost of providing  
3 telephone service. There is no reasonable basis to arbitrarily constrain the directory  
4 operations subject to imputation to only those primary directories said to be required  
5 under affiliate publishing agreements, because the value of service transactions  
6 between the telephone company and the affiliate publisher are only fully captured  
7 when all profitable directory publishing opportunities are exploited.  
8

9 Q. Has Dex incurred any significant costs or investment risks associated with  
10 publishing secondary books?

11 A. No. The Dex business has consistently positive and growing income and revenues  
12 over the past decade and there is no evidence that significant risks or costs  
13 associated with the addition of Secondary Directories has been a burden to  
14 shareholders.  
15

16 Q. What is the nature of the dispute involving "non-Qwest listings", the issue appearing  
17 at line 11 of Confidential Exhibit MLB-1?

18 A. The Company seeks to retain a significant additional share of the gain to be realized  
19 upon the sale of Dex because its primary printed directories contain some listings  
20 that are not QC telephone company customers. Qwest proposes to carve out part  
21 of its directory revenues (and an equivalent share of the Dex sale gain) based upon  
22 the percentage of listings contained within its primary directories that are not Qwest  
23 telephone subscribers. For example, if the white pages listings in Phoenix are  
24 determined to contain 90 percent QC customers and 10 percent customers who are  
25 served by competitive or independent local exchange carriers, the Company would

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76, page 7.

1 attribute 10 percent of yellow pages advertising revenues (and the resulting Dex  
2 gain) to its shareholders. This proposed carve out, like Qwest's treatment of  
3 secondary directories, appears related to the Company's theory that imputation has  
4 been ordered only because the listings of telephone company subscribers appear  
5 within Qwest directories.  
6

7 Q. Has imputation been required by regulators solely because of the inclusion of the  
8 telephone company's listings within the published directories?

9 A. No. There are many linkages between the telephone company and the directory  
10 publishing operation, only one of which is the listing linkage. My earlier testimony  
11 explained the many bases for imputation.  
12

13 Q. Were non-Qwest listings included within the directories that were published by  
14 Mountain Bell, prior to transfer of directory assets into the publishing affiliate in  
15 1984?

16 A. Yes.<sup>46</sup>  
17

18 Q. Does Dex seek to include the listings of CLECs and independent telephone  
19 companies in its directories, without regard to any obligations that may require such  
20 inclusion?

21 A. Yes. Directory customers receive more "value" for their paid advertising in a more  
22 comprehensive directory that includes all relevant listings within a market area and  
23 that is distributed to more customers. Thus, it is simply good business to publish  
24 the most complete possible directories and in doing so Dex management is simply  
25 doing its job. Dex delivers its directories to every address located within the

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46 Id. Page 8.

1 geographic scope of each of its directories and the advertising is targeted to all  
2 customers in the area, without regard to which CLEC or ILEC provides telephone  
3 service to the customer. Qwest should not be allowed to inject arbitrary criteria into  
4 the allocation of the Dex sale gain, based upon the inclusion of non-Qwest listings  
5 or the discretionary publication of secondary directories, when the decisions to  
6 expand the scope of directories in these ways is simply reflective of prudent, profit-  
7 maximizing behavior.  
8

9 Q. Has Dex absorbed any added costs or risks in order to publish secondary  
10 directories or to include non-Qwest listings in its directories?

11 A. No. It is my understanding that Dex revenues and profits have consistently grown  
12 throughout the years when the scope of published directories expanded to include  
13 additional secondary directories and non-Qwest listings. Therefore, Dex has not  
14 absorbed any additional costs or assumed any uncompensated risks by producing  
15 secondary directories or more complete primary directories that contain the  
16 customer listings of QC, CLECs and ILECs that provide telephone services within  
17 Dex directory market areas. In fact, in its response to Data Request STF 2-124S1,  
18 the Company stated, "Dex believes that putting its directories in the hands of as  
19 many users as possible enhances the value of its directories." As in the case of  
20 discretionary Secondary directories, the inclusion of non-Qwest listings is valuable  
21 to Dex in the production of more complete directories that are more attractive to  
22 advertising customers. This sort of strategic planning that is sensitive to customer  
23 needs is to be expected of management and, in my opinion, does not justify carving  
24 out a large share of the Dex sale gain for retention by shareholders.  
25

1 Q. What is the overall impact upon the Dex sale gain of the Company's proposed  
2 carve-out allocations to secondary directories and non-Qwest listings within primary  
3 directories published by Dex?

4 A. At line 12 of Confidential Exhibit MLB-1, the cumulative difference in allocations  
5 indicates that Qwest's new proposals regarding secondary directories and non-  
6 Qwest listings would improperly remove approximately (START CONFIDENTIAL)  
7 [REDACTED] (END CONFIDENTIAL) of the Dex sale gain for retention by  
8 shareholders. Across the 14-state QC service territory, this treatment would reduce  
9 the gain potentially attributable to customers by more than (START  
10 CONFIDENTIAL) [REDACTED] (END CONFIDENTIAL) on a post-tax basis, as shown at  
11 line 13 in column D.  
12

13 Q. Why is the Arizona percentage allocation proposed by Staff at line 15 of  
14 Confidential Exhibit MLB-1 different than the percentage proposed by Qwest in its  
15 response to Data Request STF 2-68?

16 A. The Company's proposed Arizona allocation percentage is based upon the ratio of  
17 Arizona directory revenues to total Dex directory revenues, excluding secondary  
18 directories and non-Qwest listings. However, since Staff opposes Qwest's  
19 exclusion of secondary directories and non-Qwest listings within primary directories,  
20 the Arizona allocation percentage must be recalculated to maintain consistency  
21 using revenues from all directories. A relatively higher share of Dex secondary  
22 directory revenues are earned in Arizona than in other states, so Staff's inclusion of  
23 secondary directory revenues in calculating the allocation factor tends to increase  
24 the Arizona share of overall Dex revenues. If the Commission agrees with the  
25 Company's proposed carve out of secondary directories and non-Qwest listings, the

1 lower Arizona percentage calculated by Qwest and shown in column B should be  
2 employed to maintain consistency.  
3

4 Q. What is shown at line 16 of Confidential Exhibit MLB-1?

5 A. Line 16 shows the Arizona share of the anticipated Qwest Dex after-tax gain on  
6 sale, under the Company's allocation approach in column B, and as proposed by  
7 Staff in column C. Because these amounts are net of accrued income taxes (from  
8 line 5) it is necessary to factor-up to a pretax equivalent value for comparison to  
9 imputation revenues. This factor-up appears at lines 17 and 18.  
10

11 Q. Is the amount shown at line 18 the total Dex pretax gain on sale amount properly  
12 attributed to the Arizona jurisdiction?

13 A. Yes. This is the amount available, pursuant to the negotiated terms of the Dex sale  
14 transaction and after the allocations just described, to fund annual revenue credits  
15 in lieu of imputation or other forms of benefit to Arizona customers.  
16

17 Q. At line 19, you show the amount of imputation ordered by the Commission in the  
18 last settled Arizona rate case. Does this amount represent an ongoing customer  
19 benefit that is embedded within current rates and revenues that was derived  
20 pursuant to the 1988 Settlement Agreement?

21 A. Yes.  
22

23 Q. Has the Company proposed the ultimate removal or adjustment of the embedded  
24 imputation amount?

25 A. No. The Company appears to support continued application of the 1988 Settlement  
26 Agreement after Dex is sold, even though that Agreement cannot reasonably be

1 applied to the new transaction or to a non-affiliate publishing arrangement.  
2 According to Company witness Arnold, "Finally, the 1988 Settlement Agreement  
3 ensures that this transaction will not impact QC rates, and provides for continued  
4 imputation to the benefit of ratepayers."<sup>47</sup> This testimony seems to imply that  
5 Qwest supports imputation in the annual amount of \$43 million, but the Company  
6 makes no firm or permanent commitment to not challenge future imputation in future  
7 regulatory proceedings. As noted in my earlier testimony, Qwest proposed reducing  
8 imputation to zero in its most recent Arizona rate filing under its interpretation of the  
9 1988 Settlement Agreement at that time.  
10

11 Q. Does the pending sale of Dex provide an opportunity to resolve directory imputation  
12 issues with some finality?

13 A. Yes. The sale of Dex provides a liquidating gain on sale value for the directory  
14 publishing business as well as an extraordinarily large cash payment for  
15 consideration by regulators. In my opinion, the Arizona customers of QC are  
16 entitled to the pretax value shown at line 18 of Confidential Exhibit MLB-1 as of the  
17 date of closing the Rodney transaction. Fortunately, the extraordinarily large cash  
18 value for Dex that is being realized in the sale, in spite of the lower sale price  
19 caused by QCI's financial predicament, is sufficient to fund: 1) substantially  
20 increased annual imputation to replace the insufficient amounts under the 1988  
21 Settlement Agreement, or 2) continuation of present imputation at \$43 million per  
22 year with a substantial immediate credit to customers to mitigate the risks arising  
23 from the transaction. Staff recommends the first alternative, in order to correct and  
24 update the obsolete customer credits within the 1988 Settlement Agreement while  
25 also preserving more cash flow for QCI debt repayment.

---

47 Direct Testimony of Maureen Arnold, page 20.

1 Q. Referring to Confidential Exhibit MLB-1, how did you calculate the increased annual  
2 credits to Arizona customers equal to the \$100 million per year in place of  
3 embedded imputation, as shown at line 20?

4 A. The proposed "Perpetual Revenue Credits for Price Regulation" represents the  
5 annual value of a perpetuity based upon the Arizona pretax gain amount on line 18.  
6 The discount rate used in this calculation is the 9.61 percent fair rate of return  
7 stipulated by Staff and USWC and approved by the Commission in USWC Docket  
8 No. T-1051B-99-105. I recommend that the Arizona share of the gain be attributed  
9 to customers through this perpetual benefit if price cap regulation is continued, as  
10 updated compensation for the value of services being transferred pursuant to the  
11 new Publishing Agreement and Noncompetition Agreement between Qwest and the  
12 Buyer of Dex.

13  
14 Q. Why is it appropriate to use a perpetual revenue credit if price cap regulation is  
15 continued?

16 A. Under price cap regulation, rate cases are not required and therefore, there is no  
17 periodic opportunity to change or remove the amount of directory-related revenue  
18 credits. The revenue credit to be employed in the Commission's review of the initial  
19 price cap plan should be a perpetual amount to reflect the permanence of revenue  
20 changes that may be ordered in that review. Under this perpetuity calculation,  
21 ratepayers would forever receive this revenue benefit, while shareholders retain the  
22 underlying gain value principal amount.

23  
24 Q. Is a different annual revenue credit amount more appropriate if Arizona price cap  
25 regulation is discontinued upon review by the Commission?

1 A. Yes. At line 21 of Exhibit MLB-1, I provide a larger annual revenue credit amount of  
2 \$121.3 million based upon a traditional 20-year amortization of the Arizona share of  
3 the Dex gain. This amount is larger because of the scheduled 20-year period,  
4 rather than a perpetual credit, and because the principal amount of the gain is  
5 distributed to customers to fully reflect the value of fees and services between the  
6 Buyer and seller of Dex.  
7

8 Q. Why is a 20-year period appropriate for amortization of the Dex gain under  
9 traditional regulation?

10 A. It is difficult to predict how telecommunications services may be provided or  
11 regulated in the distant future. It is probable that continuing public policy initiatives  
12 and technological changes will eventually succeed at substituting competition for  
13 regulation of such services within the next 20 years. However, in an abundance of  
14 caution, I elected to secure customer revenue credits for this entire period. In any  
15 traditional rate case test period calculations of revenue requirement that might occur  
16 after the year 2023, the annual revenue credits would cease and rate increases  
17 may be required for other service.  
18

19 Q. What is shown on page 2 of Exhibit MLB-1?

20 A. Calculations are presented on page 2 to determine the net present value of annual  
21 revenue credits of \$43 million and of \$121.3 million over the 20 year period. These  
22 amounts are then carried forward to page 1, line 23, to indicate how the present  
23 value of these credits compares to the Arizona share of the Dex gain at line 18.  
24

1 Q. In the event the Commission agrees with Qwest that annual imputation should not  
2 be increased above the \$43 million in the 1988 Settlement Agreement, is there is a  
3 residual amount available for a one-time crediting to Arizona ratepayers?

4 A. Yes. The present value of the \$43 million annual imputation value is much lower  
5 than the value of fees and services being derived upon sale of Dex. The residual  
6 gain amount should be credited to Arizona customers.  
7

8 Q. What amount of one-time credit to Arizona ratepayers should be ordered as a  
9 condition of Dex sale approval in this Docket, if the embedded amount of imputation  
10 is not increased?

11 A. Lines 23 and 24 of Confidential Exhibit MLB-1, in Column B, reflect the present  
12 value of Continued Embedded Imputation using the same 9.61% discount rate,  
13 assuming a 20-year period and assuming a perpetuity, respectively. After  
14 subtracting these present value amounts associated with continued \$43 million  
15 annual imputation on these lines from the Pretax Arizona Value at line 18, a large  
16 "Residual Value Not Used for Imputation Credits" remains at lines 25 and 26 in  
17 amounts ranging from \$593 to \$671 million.  
18

19 Q. What should be ordered by the Commission with respect to these Residual Values?

20 A. At least \$593 million of the Dex sale proceeds should to be credited to Arizona  
21 customers on a one-time basis, as a bill credit after the Rodney transaction is  
22 closed, if Staff's primary recommendation to increase annual imputation from \$43  
23 million to \$100 million (under price cap regulation) is not approved. This  
24 recommendation presumes perpetual revenue credits of \$43 million for ratemaking  
25 purposes, which is the assumption most compatible with existing price cap  
26 regulation.

1 Q. Why is a one-time credit to QC Arizona customers for the residual Dex sale Arizona  
2 gain amount appropriate?

3 A. Staff's primary recommendation is to adjust and update the ongoing imputation  
4 value to compensatory levels and not impose large cash credits to flow the Arizona  
5 share of the Dex gain to customers. However, as explained in my earlier testimony,  
6 the Dex directory publishing business represents an affiliate enterprise that derives  
7 considerable value from the official publisher linkages into the telephone company.  
8 The sale of Dex is an extraordinary event that yields a gain to be attributed to  
9 customers. The Arizona share of this gain should first be used to adjust and update  
10 embedded imputation, with any residual gain above this amount flowed to  
11 customers as a one-time credit so as to reflect the value of fees and services  
12 flowing to Qwest upon sale of Dex.

13  
14 Q. Is the percentage of Dex proceeds that you propose for credits to customers a  
15 relatively minor portion of the overall anticipated Dex proceeds on sale?

16 A. Yes. Staff's primary recommendation is to modify and increase embedded  
17 imputation by either \$57 or \$78 million per year. These values represent less than  
18 1.2 percent of total Dex sale proceeds in each future year. If imputation is not  
19 adjusted, the Residual Value on line 26 represents about 8.4 percent of the gross  
20 proceeds.

21  
22 Q. Should the Commission be discouraged from either increasing imputation or  
23 imposing a one-time \$593 or \$671.5 million customer credit in Arizona because the  
24 amount represents a large percentage of annual revenues earned by QC in the  
25 State?

1 A. No. QCI will realize the large gain from the sale of Dex within its income statement,  
2 but will not be recording a reasonable share of this gain within the Arizona QC  
3 income statement. If the Arizona share of the Dex gain were credited into the  
4 Arizona books, the gain would more than offset an accounting accrual for the  
5 customer credits being proposed by Staff. The residual customer credit is proposed  
6 by Staff as a secondary recommendation and should be thought of as funded by the  
7 parent entity that is realizing the large gain on sale associated with liquidation of  
8 Dex.

9  
10 Q. Will the imposition of either increased imputation or a one-time customer credit in  
11 Arizona, combined with reasonably expected regulatory impacts from the Utah and  
12 the Washington Commissions, where the Dex sale transaction is also under  
13 consideration, cause QCI to fail in its efforts to de-lever its balance sheet and  
14 improve its credit ratings?

15 A. The Utah Commission has ordered one-time customers credits of \$22 million and  
16 continued annual imputation at amounts currently embedded in rates, pursuant to a  
17 Stipulated Agreement among parties to the Dex sale proceedings. It is difficult to  
18 predict the regulatory outcome in Washington that may involve customer credits  
19 from the Dex gain on sale, but if one assumes a regulatory response in that state  
20 that is proportionate to my recommendation in Arizona, the majority of the Dex gain  
21 on sale and cash proceeds will be retained for shareholders and will be available to  
22 the Company to reduce outstanding debt.<sup>48</sup>

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48 In the Company's highly confidential financial projections provided in response to Data Request STF 2-115S1, the Rodney proceeds were (START HIGHLY CONFIDENTIAL) [REDACTED] (END HIGHLY CONFIDENTIAL). Paragraph 2.5 of the Rodney Agreement that provides for the payment of up to \$300 million of the purchase price at closing by Buyer tendering "Buyer Securities" in lieu of cash. Even with these (START HIGHLY CONFIDENTIAL) [REDACTED]

1 Q. How should the increased revenue credit values to replace imputation under Staff's  
2 primary recommendation be considered by the Commission?

3 A. The Company's existing Price Cap Plan is nearing completion of its initial term. A  
4 filing is required to evaluate performance under the plan nine months prior to the  
5 third anniversary of the Plan. Increased revenue credit values can be considered in  
6 evaluating earnings experienced by the Company under price cap regulation and  
7 any appropriate adjustments to rates and revenues can be considered as part of  
8 any Commission renewal or modification of the Price Cap Plan.

9 **Rebuttal to Qwest Witnesses**

10  
11 Q. At page 11 of her testimony, Ms. Arnold states, "First, this transaction will not result  
12 in increased capital costs to QC." Has the Company made any showing of how its  
13 future cost of capital attributable to the regulated operations of QC will be impacted  
14 by the sale of Dex?

15 A. No. Ms. Arnold refers to Mr. Cummings' testimony in support of this conclusion.  
16 However, Mr. Cummings' testimony indicates only that the sale of Dex has favorably  
17 impacted the QCI stock price and credit spreads in recent periods, with no apparent  
18 evaluation of the longer-term cost of capital consequences associated with the loss  
19 of Dex income and cash flows. The QCI stock price remains quite depressed and is  
20 presently (week of March 25, 2003) below the \$4 to \$5 per share range mentioned  
21 by Mr. Cummings at page 23 of his testimony.  
22

23 Q. Another assertion by Ms. Arnold at page 11 is that, "Second, this transaction will not  
24 result in the allocation of any additional cost to the Arizona jurisdiction since no DEX

---

(END HIGHLY CONFIDENTIAL).

1 costs have ever been allocated to Arizona regulated results of operations." How do  
2 you respond?

3 A. Arizona expenses are likely to increase as a direct result of the sale of Dex. It is my  
4 expectation that the shared corporate administrative costs of the corporation, that  
5 are presently subject to allocation among QC, Dex and other QCI subsidiaries, will  
6 be subject to larger allocations to QC after the Dex business has been sold is no  
7 longer receiving an allocation of such costs. As noted in my earlier testimony, the  
8 Company has performed no studies of these effects and the Transition Services  
9 Agreement (Exhibit K) will charge some of these costs that were previously  
10 allocable to Dex to the Buyer of Dex for only the first 18 months after closing.  
11 Beyond that date, it is quite likely that QC will absorb a larger share of shared  
12 administrative overheads.

13 There is also a new "Advertising Commitment" that obligates QCI and QC to  
14 take or pay for a specified amount of directory advertising from the Buyer of Dex  
15 that may increase costs charged or allocated to QC in the future.  
16

17 Q. At page 12, Ms. Arnold asserts, "Third, the transaction will not result in a reduction  
18 of QC's net operating income." Is this correct?

19 A. No. The same concern regarding administrative overhead cost reallocations and  
20 the Dex advertising commitment would have the effect of reducing QC's net  
21 operating income.

22  
23 Q. At pages 16 and 17 of her testimony, Ms. Arnold describes QC's directory  
24 publishing obligations under the Federal Telecommunications Act of 1996 and the  
25 Arizona Commission's rules and explains how these specific obligations are met  
26 under the current and proposed directory publishing agreements. Has the existing

1 affiliate publishing agreement between QC and Qwest Dex ever been found by the  
2 Commission to be reasonable in the way it compensates QC for the official  
3 publishing rights transferred to Dex?

4 A. No. The existing form of affiliate publishing agreement made effective between the  
5 directory publisher and the affiliate regulated telephone company has not been  
6 accepted and was consistently restated by the Commission via ratemaking  
7 imputation adjustments, because these agreements failed to fairly compensate the  
8 telephone company as required under the Settlement Agreement. The new  
9 Publishing Agreement with the Buyer of Dex also provides no compensation to the  
10 telephone company for the valuable ILEC official publishing rights. The negotiated  
11 \$7.05 billion price for Dex is largely reflective of this valuable official publishing right  
12 that is being purchased from QCI for cash and then being secured by long-term  
13 Publishing and Non-Competition Agreements that prevent the ILEC from re-entering  
14 the directory business and eroding this value.

15  
16 Q. At pages 7 and 8 of his testimony, Qwest witness Mr. Burnett refers to efforts made  
17 to expand and improve the directory publishing business that have been made  
18 since the 1984 transfer outside the telephone company. Do these enhancements or  
19 the additional revenue they produce justify attributing a portion of the value of the  
20 gain on sale of Dex to shareholders, rather than QC customers?

21 A. No. Changes made to printed directories, such as the improvement of fonts,  
22 inclusion of color maps, community information pages, colored advertising and  
23 white pages enhancements should not be attributed to shareholders at all, because  
24 such improvements are simply the result of prudent business management and did  
25 not entail any significant startup costs or risks to shareholders. I explained in earlier

1 testimony why Dex earnings associated with secondary directories and non-Qwest  
2 listings in primary directories should not be attributed to shareholders.

3  
4 Q. Mr. Burnett describes the relationship between Dex and QC at page 4 of his direct  
5 testimony, stating, "All the tangible and intangible assets, intellectual property,  
6 human resources and operational know-how for directory operations were  
7 transferred to the new entity." Was any compensation provided to the telephone  
8 company or its customers when all of these assets were "transferred to the new  
9 entity"?

10 A. No. The telephone company received compensation for \$56.3 million of cash and  
11 \$8.334 million in fixed assets including a building, PBX, motor vehicles, furniture  
12 and computers that were transferred to the affiliate, less a \$2.0 million accounts  
13 payable liability at the formation of U S West Direct, as referenced in the Company's  
14 response to Data Request STF 4-156. There was no compensation for the fair  
15 market value of the directory publishing business enterprise paid to the telephone  
16 company or its customers in 1984, as no true sale of the business occurred on that  
17 date. The Commission initially rejected the transfer that occurred in 1984 and later  
18 approved the 1988 Settlement Agreement that resolved litigation surrounding this  
19 matter, subject to imputation of \$43 million per year as ongoing compensation for  
20 the use of these types of intangible assets.

21  
22 Q. Is it possible for any of the \$56.3 million of cash that was transferred to the new  
23 publishing affiliate in 1983 to now be part of what is being sold to the Buyer of Dex?

24 A. No. Schedule 2.2 of the Contribution Agreement (Exhibit B) related to the Dex  
25 Purchase agreements lists "Cash and cash equivalents" in the list of "Excluded  
26 Assets" not being conveyed to the Buyer of Dex.

1 Q. Is it likely that the \$8.334 million in fixed assets, including a building, PBX, motor  
2 vehicles, furniture and computers, that were transferred to the publishing affiliate in  
3 1984 are now included in the pending sale of Dex?

4 A. No. The same Rodney Contribution Agreement (Exhibit B) lists a number of Dex  
5 leasehold interests in facilities that are part of the "Contributed Assets" in Schedule  
6 2.1, but this listing includes no Dex-owned buildings. In fact the first item on the list  
7 of "Excluded Assets" in Schedule 2.2 of the Dexter Agreement is "Seller's interests  
8 in all real estate located outside the Transfer Region (all such real estate  
9 collectively, the "Excluded Facilities") and the fee interest in the 198 Inverness Drive  
10 Building." Thus, it appears that no buildings are being conveyed to the Buyer of  
11 Dex. It is unlikely that any significant amount of PBX, motor vehicles, furniture or  
12 computers that were in service in 1984 are still serviceable and included in the Dex  
13 sale 19 years later.  
14

15 Q. At page 5 of his Direct Testimony, Mr. Burnett discusses the existing Publishing  
16 Agreement between Dex and QC that designates Dex as the "official publisher" for  
17 QC. Then at page 6 he states, "QC does not pay Dex for the services that Dex  
18 performs, nor does Dex pay QC under the Publishing Agreement for the right to be  
19 QC's official publisher." Has the Commission ever accepted this arrangement for  
20 purposes of regulation in Arizona?

21 A. No. Imputation adjustments have been required in Arizona in rate cases since 1984  
22 because of the inadequate compensation received by the telephone company under  
23 the affiliate Publishing Agreement. The new Publishing Agreement with the Buyer  
24 of Dex will perpetuate this arrangement, where no compensation is provided to the  
25 telephone company for the "official publisher" designation or for the many other  
26 beneficial linkages to the telephone company that are provided. These benefits

1 under the Publishing Agreement and other commercial agreements are secured by  
2 the new Non-competition Agreement in favor of the Buyer and represent a large part  
3 of what is being purchased for \$7.05 billion.

4 **Conclusion**  
5

6 Q. In your opinion, based upon the evidence sponsored by Qwest witnesses in this  
7 Docket and the work you have done to evaluate the proposed Dex sale transaction,  
8 should the Commission approve the sale of Dex?

9 A. The proposed Dex sale is vital to the efforts of Qwest to improve liquidity and  
10 maintain access to capital on reasonable terms. Therefore, the Dex sale should be  
11 approved by the Commission, but only if QC customers in Arizona are afforded  
12 adequate and equitable participation in the financial benefits of the transaction and  
13 protection against the risks associated with the transaction. The Arizona share of  
14 the Dex sale gain should be used to increase the currently understated imputation  
15 of \$43 million level that is embedded within present rates, to a new level of \$100  
16 million per year assuming continued price cap regulation or \$121.3 million for each  
17 of the next 20 years assuming traditional regulation. In the event such an increased  
18 imputation is not ordered, the remaining Arizona share of the gain calculated on  
19 Confidential Exhibit MLB-1, after accounting for continuation of current imputation at  
20 \$43 million, should be treated as an extraordinary credit to customers on a one-time  
21 basis, or at the discretion of the Commission, directed toward customer-funded  
22 service quality or network investment initiatives with rigorous regulatory oversight  
23 and accounting controls. With these financial conditions, and the infrastructure and  
24 publishing conditions stated at pages 43 and 44 of my testimony, approval of the  
25 proposed Rodney transaction can be found to be consistent with the public interest.  
26

- 1 Q. Does this conclude your testimony at this time?
- 2 A. Yes.

Sale of Dex - Estimated Gain to Arizona				
Line #	Description	Per Company Staff DR 2-68 \$ Millions (B)	Staff Position \$ Millions (C)	Difference At Issue (D)
	(A)		(C)	(D)
1	Sale Price of Qwest Dex	\$ 7,050	\$ 7,050	
2	Less: Estimated Contributed Assets			
3	Transaction Costs			
4	Estimated Pretax Gain on Sale			
5	Income Tax on Gain 39.53% FIT/SIT			
6	Estimated Post-tax Gain on Sale			
7	<u>Gain Allocation to Shareholders:</u>			
8	Allocation to LCI			
9	Allocation to New Ventures			
10	Allocation to Secondary Directories			
11	Allocation to non-Qwest Listings			
12	Total Gain Allocation to Shareholders			
13	Shareholder Gain Amount			
14	Residual = Gain to QC Customers			
15	Approximate Arizona Share			
16	Arizona Intrastate Share of Dex Gain - Post Tax		\$ 629	
17	Income Tax Factor-Up (1/[1-.3953] composite FIT/SIT rate)		1.6537	
18	Pretax Arizona Value For Customer Attribution		<u>\$ 1,040.5</u>	
<u>Alternative Annual Revenue Credits (\$ millions)</u>				
19	1988 Settlement Agreement Level of Imputation Credit	\$ 43.0		
20	Perpetual Revenue Credits For Price Cap Regulation		\$ 100.0	
21	20 Year Fixed Revenue Credits For Traditional Regulation			\$ 121.3
22	<u>Present Value of Alternative Annual Revenue Credits</u>			
23	Present Value of Revenue Credit for 20 Years	\$ 369.0		\$ 1,040.5
24	Present Value of Revenue Credit in Perpetuity	\$ 447.5	\$ 1,040.5	
25	Residual Value Not Used for Annual Credits - 20 Years	\$ 671.5		\$ (0.0)
26	Residual Value Not Used for Annual Credits - Perpetual	\$ 593.0	\$ -	

Confidential

Qwest Dex Sale Application  
 Arizona Docket No. T-01051B-02-0666  
 Gain on Sale Allocation to Arizona

Exhibit \_\_\_\_ (MLB-1)  
 Page 2 of 2

Year	Description (A)	Principal Amount (B)	9.61% Discount Factor Half Year Used (C)	Present Value (D)
1	Present Value of Current \$43 Million Imputation	\$ 43.00	0.950736557	\$ 40.88
2		43.00	0.859370773	36.95
3		43.00	0.776785242	33.40
4		43.00	0.70213618	30.19
5		43.00	0.634660893	27.29
6		43.00	0.573669982	24.67
7		43.00	0.518540296	22.30
8		43.00	0.468708574	20.15
9		43.00	0.42366568	18.22
10		43.00	0.382951408	16.47
11		43.00	0.346149778	14.88
12		43.00	0.312884784	13.45
13		43.00	0.282816556	12.16
14		43.00	0.255637885	10.99
15		43.00	0.231071085	9.94
16		43.00	0.208865153	8.98
17		43.00	0.188793212	8.12
18		43.00	0.170650184	7.34
19		43.00	0.154250702	6.63
20		43.00	0.139427209	6.00
				<u>\$ 369.02</u>
1	Present Value of Proposed Revenue Credits	\$ 121.25	0.950736557	\$ 115.28
2		121.25	0.859370773	104.20
3		121.25	0.776785242	94.19
4		121.25	0.70213618	85.13
5		121.25	0.634660893	76.95
6		121.25	0.573669982	69.56
7		121.25	0.518540296	62.87
8		121.25	0.468708574	56.83
9		121.25	0.42366568	51.37
10		121.25	0.382951408	46.43
11		121.25	0.346149778	41.97
12		121.25	0.312884784	37.94
13		121.25	0.282816556	34.29
14		121.25	0.255637885	31.00
15		121.25	0.231071085	28.02
16		121.25	0.208865153	25.32
17		121.25	0.188793212	22.89
18		121.25	0.170650184	20.69
19		121.25	0.154250702	18.70
20		121.25	0.139427209	16.91
				<u>\$ 1,040.54</u>